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NOMINATION OF JAMES A. BAKER III

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

NOMINATION OF

JAMES A. BAKER III TO BE SECRETARY OF THE TREASURY

JANUARY 23, 1985

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
43-093 O WASHINGTON : 1985

S361-48

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NOMINATION OF JAMES A. BAKER III OF TEXAS, TO BE SECRETARY OF THE TREASURY

WEDNESDAY, JANUARY 23, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Dole, Roth, Danforth, Chafee, Heinz, Wallop, Durenberger, Symms, Grassley, Long, Matsunaga, Moynihan, Baucus, Boren, Bradley, Mitchell, and Pryor.

[The press release announcing the hearing and the prepared statements of Senators Dole, Grassley, Bentsen, and Baucus follow:]

[Press Release No. 85-101]

FINANCE COMMITTEE SETS DATES TO CONSIDER NOMINATION

Senator Bob Packwood (R., Ore.), Chairman of the Committee on Finance, announced today that the Committee would conduct a hearing and then meet in executive session on Wednesday, January 23, 1985, on the nomination by President Reagan of James A. Baker III, of Texas, to be Secretary of the Treasury.

The hearing will commence at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Since 1981, Mr. Baker has been Chief of Staff and Assistant to the President. From 1977 to 1981, he was a Partner in the firm of Andrews, Kurth, Campbell and Jones located in Houston, Texas. Prior to that time, Mr. Baker was Deputy Chairman and Chairman of the President Ford Committee from May 1976 to December 1976; and Undersecretary of Commerce from August 1975 to May 1976.

Mr. Baker received a B.A. from Princeton University and J.D. from the University of Texas Law School.

Written statements.—Persons who desire to present their views to the Committee regarding this nominee should prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be typewritten, not more than 10 double-spaced pages in length, and mailed with five (5) copies to Anne Cantrel, Administrative Director, Committee on Finance, Room SD-219, Dirksen Senate Office Building, Washington, D.C. 20510, not later than January 29, 1985. On the first page of the written statement, please indicate the date and subject of the hearing.

STATEMENT OF SENATOR DOLE

Mr. Chairman: I congratulate you on convening this committee so promptly to review the President's nomination of James Baker to be Secretary of the Treasury, replacing Don Regan, who will be moving to the White House as Chief of Staff. Swift action on Jim Baker's nomination is important—not just because of the outstanding qualifications both he and Don Regan will bring to their new jobs, but because it is vital that the President get his team in order and working at top strength as soon as possible. The ambitious agenda President Reagan outlined yesterday in his second inaugural address demands the immediate attention of Jim

Baker at the Treasury Department, so that he can bring to bear on that agenda the exceptional skills he has demonstrated at the White House over the past four years.

A DISTINGUISHED RECORD

Those of us who have worked with Jim Baker, particularly in advancing President Reagan's economic program, have no doubt that he is eminently qualified to serve as Secretary of the Treasury. Jim has been closely involved in the formulation and implementation of the President's tax and budget policies, and he has proven extremely effective in working with us in Congress. The importance of that skill should not be underestimated, given the President's ambitious economic agenda. Major spending cuts to reduce the deficit are our top priority, and no doubt Jim Baker will continue to focus primarily on that goal as he moves into the role of chief economic officer of the administration. But tax reform, constitutional reform of our fiscal policy, and maintaining good economic relations around the globe also are important President Reagan, and will demand a firm guiding hand at Treasury.

Jim Baker's experience is by no means confined to the White House. He has served as Under Secretary of Commerce under President Ford, and he has been active in politics for many years—with considerable success, I might add. He has had a distinguished legal career, and he has served on the boards of many major companies. But most important of all, he knows us and he knows President Reagan, and he has won the confidence of those who govern from both ends of Pennsylvania Avenue. He will be able to get the job done that must be done on the economic front.

SENSE OF URGENCY

Mr. Chairman, I hope the Finance Committee will move the nomination of James Baker to be Secretary of the Treasury without delay, so the Senate can act. The sooner we have all the players in place, the sooner we can complete legislative action to reduce the budget deficit. The work we have done in Senate discussions so far, with the cooperation of the administration, should enable us to pass a major spending reduction, 'freeze plus' package that will secure and consolidate the tremendous economic gains of the past four years. Inflation subdued, tax rates controlled, regulation reduced, the growth of spending restrained—all of these achievements have made our citizens' economic future look much brighter than anyone could have imagined four years ago. Anyone, that is, except Ronald Reagan, who led the way to economic recovery with the help of able lieutenants like Jim Baker and Don Regan. But we cannot relax now, with the challenge of the deficit still before us. Time is wasting, and the sooner we have Messrs. Baker and Regan in their new posts, the sooner we can get the job done.

STATEMENT OF SENATOR CHUCK GRASSLEY

I would like to begin my remarks by offering publicly my congratulations to you, Mr. Baker. After four years of faithful and good service to President Reagan as his chief of staff, you have managed to jump out of the frying pan and into the fire. I must say that I am encouraged that President Reagan has chosen a trusted aide, a man who has experience in Washington and Administration politics, to take up the important post of Secretary of the Treasury.

As you are probably aware, farmers and businessmen in Iowa are experiencing grave difficulties brought on by high interest rates and poor international exchange rates. Both of these problems can be traced directly to the high deficits we have been running in the last four years and the monetary policies of the Federal Reserve Board. I hope that you will make it a priority to lend your support and encouragement to the effort to freeze federal spending, preferably across the board. I also hope that you will continue Secretary Regan's efforts to work with Chairman Volker for interest rate relief.

As chairman of the IRS Oversight Subcommittee, I have been encouraged by the progress made under Commissioner Egger in making the IRS more responsive to taxpayers. I hope for continued progress in that area, and I particularly would encourage you and Commissioner Egger to monitor the IRS to see that its personnel are thoughtful and helpful in their dealings with individual taxpayers.

STATEMENT OF HON. LLOYD M. BENTSEN

I would like to welcome Jim Baker but, Mr. Chairman, before I do that, I would like to welcome you to your new post as chairman of this committee. More than ever, tax policy is at the forefront of political debate in this country and with your skills and experience I am sure you will be able to make a lasting contribution to our country's tax policy. Mr. Chairman, I look forward to working closely with you during this 99th Congress.

Now for a few words about Jim Baker.

Mr. Chairman, to run the Treasury Department properly takes a unique blend of tax and business acumen and hard work: A Secretary must have a sense of how our tax laws affect the decisions of individuals and businesses and of what a fair tax policy is. And he must have the perseverance and determination to push through to completion in sometimes difficult circumstances. Jim Baker has these qualities.

Mr. Baker was engaged in a private legal practice in Texas for twenty years. He also has the experience of serving on numerous corporate boards. I think he will be able to appreciate the effect of the tax laws on business and personal decisions and on the economy. As former Treasury Secretary and fellow Texan John Connally pointed out last week, "He knows that lower interest rates are good for the country." At the same time, he will bring to his new job a knowledge of the political system, with all its vagaries and caprices. In short, I believe he will not only be able to formulate fair and beneficial tax policies, but I think he'll be able to have them implemented.

Mr. Baker, of course, has superlative credentials—from an excellent education, to military service, to law firm partnership. And he has an impeccable reputation for integrity.

Mr. Chairman, Jim Baker comes from a family that has given our state of Texas generations of leadership. Jim has carried on in that tradition. I expect him to be confirmed by the Senate without delay and I urge the support of this Committee.

OPENING STATEMENT OF SENATOR MAX BAUCUS

Thank you, Mr. Chairman. Mr. Baker, you have been nominated to one of the most important positions in American government.

The Treasury Secretary supervises over 130,000 employees. He collects revenues worth $600 billion. And he has important responsibilities in the areas of economic development, trade, and law enforcement.

Many of America's most distinguished public servants have served as Treasury Secretary, including Alexander Hamilton, Andrew Mellon, and Henry Morgenthau.

I hope you will continue this tradition of exemplary public service, for you face many critical tasks:

We must reduce the deficit, which is increasing by $22 million an hour and mortgaging our children's future; we must restore America's international competitiveness; and we must reform the federal tax code.

Each of these tasks will require great energy, judgment, and skill. I know, from your fine record of public service, that you bring all three to the task.

All of us on the Finance Committee hope you will maintain an open working relationship with us. We hope "give and take" will be the order of the day.

Mr. Baker, I congratulate you on your nomination. I look forward to a productive working relationship.

The CHAIRMAN. The committee will come to order. We obviously gathered here today for the confirmation hearings of Jim Baker to be Secretary of the Treasury. And I can tell from a number of the comments that members have made to me already that while this is going to be a friendly session, I sense there is going to be a lot of specific questions on matters of different interest that the members have.

I personally have known Jim Baker for over 10 years. I knew him when he was an Under Secretary of Commerce; I was on the Commerce Committee. I knew him when he was in the Ford administration and handling President Ford's campaign for reelection. I knew him in the Bush campaign. I've known him well in the last 4 years, and have dealt with him on a variety of issues, and can say without any reservation that he is one of the most decent, honest, forward, able people that I have run across.

If I have any slight misgivings, it's the fact that he will be leaving a position where I've already worked with him closely and was delighted to have him. But if he has to go any place, I'm delighted that he is moving to the Treasury Department where, if anything, Jim, we will have more to do with each other than we even did in your position with the President.

Delighted to have you before us.

Senator Long.

Senator LONG. Mr. Secretary, I would like to have some idea as to how much the relationship will change between the Secretary of the Treasury and the chief assistant to the President, his Chief of Staff, under the new arrangement compared with what it was under the old arrangement.

You were the Chief of Staff at the White House, and Mr. Regan was the Secretary of the Treasury. Now he is taking your old job and you are taking his old job. I'm sure he thinks he knows all about your old job.

The CHAIRMAN. Russell, are you asking him a question? [Laughter.]

Senator LONG. Well, I was getting around to it.

The CHAIRMAN. All right. What I would like to do is let the members make some opening statements that they may want to make.

Senator LONG. You didn't say that. [Laughter.]

The CHAIRMAN. I realize that. I apologize.

Senator LONG. I will pass on making a statement.

The CHAIRMAN. What I would like to do is to follow the policy that both you and Bob Dole had followed of a first come, first serve in terms of questions and statements, and the 5-minute rule on questions and answers because it gives everyone on this committee, senior or junior, a first shot at the questions, if they want to come early. And we have done the same on opening statements. So I would like to call on Senator Dole.

Senator DOLE. I would like to include my statement as part of the record because we want to hear the witness.

I would just underscore the comments that the distinguished chairman, Senator Packwood, made. I have worked very closely with Jim Baker; I did in 1976 and even a bit before that, and ever since that time. Our biggest problems right now are economic problems, and I don't know of anyone in the administration who has worked more closely in the broad sense on the spending side and the tax side than Jim Baker. And it certainly is a priority in this Senate, this Congress, to reduce the Federal deficit.

I have found a complete willingness on his part to listen to our views and maybe even sometimes try to encourage our views upon some who had a little different view in the administration.

So I am pleased to be here and pleased to support the nomination. And I ask that my statement be made a part of the record.

The CHAIRMAN. Without objection.

Senator Chafee.

Senator CHAFEE. Mr. Chairman, I would like to say that Mr. Baker has done a marvelous job down there as chief of staff. He has been responsive to the problems that we have here on the Hill.

I think the country is extremely fortunate that someone like Jim Baker has given the time he has given to public service, and the country is fortunate he is continuing to do so. The country is lucky and all of us citizens are lucky that he is willing to undertake these new tasks. So I welcome him here and am delighted he is with us.

The CHAIRMAN. Senator Long, any opening statement?

Senator LONG. Mr. Chairman, I'm opposed to all these opening statements by Senators. I think that we came to hear the witness, not just to make speeches. I pass.

The CHAIRMAN. Senator Mitchell.

Senator Mitchell.

Senator MITCHELL. I join the other members of the committee in welcoming you, and we look forward to your answers. After the statements that have been made about you, I would leave right now. [Laughter.]

We do look forward to it. You have done a great job so far, and we look forward to working with you in your new position.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, it's hard to imagine what one can say after all the praise that we have leveled at Jim Baker. Fortunately, he's not a shrinking violet.

I'll just say this. He is going from the second toughest job in America to the second most important job in America as the President's chief economic architect. He has performed, as we have heard today, the toughest job outstandingly, with great loyalty, and with great dedication.

I have no doubt that he will perform the most important job as the economic architect of the administration's policy, that job, with every bit as much ability and success as he has his present, and soon to be former, job.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I don't think it's fair to give Mr. Baker the impression that this is the way this committee is going to treat him. [Laughter.]

Even so, I want to welcome him and say that I served in an earlier administration with him, and have the greatest admiration for him as a public person and as an individual, and I look forward to his tenure.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Mr. Chairman, Mr. Baker, all of us congratulate you on your nomination. There is no doubt that you have a very good reputation in Washington, and you have a very good reputation on this committee. And we all hope that you will live up to that reputation.

You have been nominated to one of the most important jobs in government. There have been some famous Secretaries of the Treasury in American history, such as Alexander Hamilton and Henry Morganthau. We know, as Senator Moynihan said, that we sometimes will have differences of opinion; sometimes we won't treat you with quite the same courtesy or at least give the same praise that we are giving you this morning. But we hope, anyway, that you will live up to the tradition of the position and maintain the good reputation that you now have in Washington.

We look forward to working with you.

The **Chairman**. Jim, I see that you have Senator Gramm with you. I assume he is going to make a statement on your behalf before the committee.

Senator **Gramm**. Thank you, Mr. Chairman.

The **Chairman**. It's good to have you with us for the first time in your capacity as a Senator.

Senator **Gramm**. Well, I'm glad to be here, and it's one of the happy opportunities of being Texas' new Republican Senator that I'm here to introduce Jim Baker, and to recommend to you that he be confirmed.

Jim Baker is one of the native sons of Texas. We have had many great leaders in the history of our State. We now count Jim Baker as one of those leaders, and we don't believe that the legacy of his leadership is yet fully written.

From his position as a lieutenant in the Marine Corps, to Assistant Secretary of Commerce, to Chief of Staff at the White House, Jim Baker has spent a lifetime in public service. He practiced business law for 20 years in a major law firm in Houston. He has been a civic, business, and community leader in everything that he has done.

I believe that he will be one of our Nation's great Secretaries of the Treasury, and I'm here today to recommend him to you and to give him my strong personal recommendation and the recommendation of the people of Texas.

The **Chairman**. Thank you.

Mr. Baker, do you have a statement?

Mr. **Baker**. Thank you, Mr. Chairman, and distinguished members of the committee. Thank you for your kind remarks in my behalf.

And let me start by thanking Senator Gramm and Senator Bentsen, who is home in Texas ill, as I understand it, with the flu, but has a statement that he is putting in the record.

Thank you, Mr. Chairman.

[The prepared written statement of Mr. Baker and his résumé follow:]

STATEMENT OF
JAMES A. BAKER III
BEFORE THE
SENATE FINANCE COMMITTEE
JANUARY 23, 1985

Mr. Chairman and distinguished Members of the Committee, it is a pleasure to appear before you today. I have a brief opening statement.

Please let me first thank Senators Bentsen and Gramm for the kindness of their introductions. I am most appreciative.

For the past four years, I have served in the Administration of President Reagan as Chief of Staff and Assistant to the President. But I appear before you today as the President's nominee to be Secretary of the Treasury.

During the past four years, one of my responsibilities has been to oversee the development and implementation of the President's legislative strategy. In this connection, it has been a special privilege for me to have had the opportunity to work closely with the Congress and with many members of this Committee. I am particularly grateful for the personal relationships I have developed in the process. More generally, however, I have tried to help assure that we approach relations with the Legislative Branch in a constructive, open, and fair-minded spirit -- and I have been gratified that this spirit has been consistently reciprocated. If confirmed by the Senate, I would hope and expect to continue to work with the Congress, and your Committee, in the same constructive spirit.

We have a substantial agenda before us. America is now enjoying one of the strongest economic recoveries and expansions of the post-war period. This is thanks, in part, to legislative initiatives that were adopted on a bi-partisan basis. But if we are to continue on the path of strong and sustainable economic growth without inflation -- if we are to bring the benefits of a creative and expanding economy to all Americans -- we must meet several additional challenges:

- We must, on a bi-partisan basis, bring greater fairness to the American tax system and make it simpler; we must increase incentives for savings and investment; and we must, thereby, encourage the increased productivity that is the key to a better life for all.

- We must, on a bi-partisan basis, reduce the projected deficits by cutting wasteful and unjustifiable government spending. As a start, we must work together to enact a "freeze" on total federal program outlays for fiscal year 1986 relative to 1985.

- We must pursue monetary policies that keep inflation down -- and, over the longer term, reduce it still further -- while, at the same time, we assure strong and sustainable economic growth.

- And we must help strengthen the international economic system -- for, as we do, the United States economy will enjoy the benefits of more balanced prospects for trade and investment.

All of these are matters in which I know your committee has a substantial interest and a major role. Now I would be happy to answer any questions which the committee may have.

INFORMATION REQUESTED OF NOMINEES

A. BIOGRAPHICAL:

1. James Addison Baker, III

2. 2415 Foxhall Road, N.W.
   Washington, D.C. 20007

3. April 28, 1930
   Houston, Texas

4. Married to Susan Garrett Baker

5.

James A. Baker, IV	Age 30
Stuart McHenry Baker	Age 28
John C. Baker	Age 24
Douglas B. Baker	Age 23
Mary Bonner Baker	Age 7

6. Kinkaid School
   September 1936 to June 1946

   Hill School
   September 1946 to June 1948
   High School diploma

   Princeton University
   June 1948 to June 1952
   B.A.

   University of Texas Law School
   September 1954 to June 1957
   J.D.

7. Chief of Staff and Assistant to the President
   The White House
   Washington, D.C. 20500
   January 1981 to Present

   Partner
   Andrews, Kurth, Campbell & Jones
   2500 Exxon Building
   Houston, Texas
   1967 to August 1975
   1977 to 1981
   Associate: 1957 to February 1967

   Deputy Chairman and Chairman
   President Ford Committee
   Washington, D.C.
   May 1976 to December 1976

7. Continued

Under Secretary of Commerce
Department of Commerce
Washington, D.C.
August 1975 to May 1976

Lieutenant
U.S. Marine Corps
Quantico, Virginia and Camp LeJeune, North Carolina
June 1952 to August 1954

8. Chief of Staff and Assistant to the President
The White House
1981 to Present

Under Secretary of Commerce
Department of Commerce
1975 to 1976

Member, Board of Trustees
Woodrow Wilson International Center for Scholars
1977 to Present

9. Phi Delta Theta (social fraternity)
State Bar of Texas
American Bar Association
Houston Bar Association
American Judicature Society
Member, Board of Visitors and Executive Committee
  University Cancer Foundation
  M.D. Anderson Hospital
  Houston, Texas
Member, Associate Board
  Texas Children's Hospital
  Houston, Texas
Trustee, Wilson Educational Foundation
  Houston, Texas
Director, D&D Beer Distributing, Inc.
  Omaha, Nebraska
  (1980-1981)
Director, Winston Ranch, Inc.
  Houston, Texas
  (1978-1982)
Director, Herman Bros, Inc.
  Omaha, Nebraska
  (1979-1981)
Director, Graham Realty
  Houston, Texas
  (1958-1979)
Director, Leigh Products, Inc.
  Grand Rapids, Michigan
  (1977-1979)

9. Continued

Director, Texas Commerce Bancshares, Inc.
Houston, Texas
(1977-1981)

Director, Wainoco
Houston, Texas
(1977-1980)

Director, Welltech, Inc.
Houston, Texas
(1977-1979)

Member of Management Committee
Andrews, Kurth, Campbell & Jones
Houston, Texas
(1977-1981)

10. Deputy Chairman for Delegate Operations
President Ford Committee
1976

Chairman, President Ford Committee
1976

Republican Nominee for Attorney General of Texas
1978

Chairman, George Bush for President Committee
1979-1980

Senior Advisor, Reagan-Bush Committee
1980

I have made numerous contributions over the past ten years to Republican candidates and party organizations. Though I have no ready listing of such contributions due to the large number and period of time involved, I will attempt to reconstruct or recall any particular contributions should the committee request it.

11. Phi Delta Phi (Honorary Legal Fraternity)
1983 Woodrow Wilson Award (Princeton University)

12. While in law school, I authored a number of casenotes for the Texas Law Review in 1957. I also authored an article for the Princeton Alumni Weekly ("Managing the White House"; March 23, 1983).

13. As an Administration spokesman, I have given numerous speeches over the past three years in support of or explaining Administration policies. Many of my speeches were given from notes or were extemporaneous and, therefore, no text is available.

14. Qualifications

I feel that I am qualified to serve as Secretary of the Treasury by virtue of my experience in both the Government and the private sector.

Mr. **Baker**. I have a brief opening statement, if I might.

For the past 4 years, as you have indicated, I have served President Reagan as Chief of Staff and Assistant to the President, but I appear before you today as the President's nominee to be Secretary of the Treasury.

During the past 4 years one of my responsibilities has been to oversee the development and implementation of the President's legislative strategy. In this connection, it has been a privilege for me to have had the opportunity to work closely with the Congress and with many members of this committee.

I'm particularly grateful for the personal relationships that I have developed in the process. More generally, however, I have tried to help assure that we approach relations with the legislative branch in a constructive, open, and fair-minded spirit, and I have been gratified that this spirit has been consistently reciprocated.

If I am confirmed by the Senate, I would hope and expect to continue to work with the Congress and your committee in the same constructive spirit.

We have a substantial agenda before us. America is now enjoying one of the strongest economic recoveries and expansions of the postwar period. This is thanks in part to legislative initiatives that were adopted on a bipartisan basis. But if we are to continue on the path of strong and sustainable economic growth without inflation, if we are to bring the benefits of a creative and expanding economy to all Americans, we must meet several additional challenges.

We must, on a bipartisan basis, bring greater fairness to the American tax system, and make it simpler. We must increase incentives for savings and investment, and we must thereby encourage the increased productivity that is the key to a better life for all.

We must, on a bipartisan basis, reduce the projected deficits by cutting wasteful and unjustifiable Government spending. As a start, we must work together to enact a total freeze on Federal program outlays for fiscal 1986 relative to 1985.

[A letter from the Office of Government Ethics follows:]

United States of America
Office of
Government Ethics

Office of Personnel Management
Washington, D.C. 20415

[illegible] 22

Honorable Robert Packwood
Chairman, Senate Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In accordance with the Ethics in Government Act of 1978, I enclose a copy of the financial disclosure report filed by James A. Baker III, who was nominated by President Reagan for the position of Secretary of the Treasury.

We have reviewed the report and have also obtained advice from the Department of the Treasury concerning any possible conflict in light of the Department's functions and the nominee's proposed duties. Mr. Baker established a qualified blind trust in 1981 pursuant to 5 U.S.C. App. 202(f)(3). Under the statutory scheme for this type of blind trust, an asset originally placed in the trust by Mr. Baker is considered to remain his financial interest for conflicts purposes until he is notified by the trustee that the asset has been disposed of, or has a value of less than $1,000. Thus, the trust is considered blind only as to assets subsequently purchased by the trustee. Because Mr. Baker is charged with having knowledge of those original assets that remain, the Department and this Office have also made those assets a part of this review. A descriptive list of those assets is attached for your information.

The Department of the Treasury has represented to this Office that Mr. Baker has agreed to recuse himself, or seek a waiver under 18 U.S.C. 208(b) so that he might act, in any particular matter involving a financial interest of his should such a matter arise. Based on this representation along with our review of the enclosed SF 278 and the publicly known trust assets, we believe that Mr. Baker, in serving as Secretary of the Treasury, will be in compliance with applicable laws and regulations governing conflicts of interest.

Sincerely,

David H. Martin

David H. Martin
Director

Enclosures (2)

The Chairman. Fair enough.

Mr. Baker. We must pursue monetary policies that keep inflation down and over the longer term reduce it still further, while at the same time we assure strong and sustainable economic growth.

And we must help strengthen the international economic system. For as we do, the U.S. economy will enjoy the benefit of more balanced prospects for trade and investment.

All of these are matters in which I know your committee has a substantial interest and a major role.

Now I would be happy to answer any questions that the committee might have.

The Chairman. Mr. Baker, thank you.

Again following the rule that both Senator Long and Senator Dole used, we will go on a first-come, first-served basis for questions, and the clerk will hold us to 5 minutes, please. And we will start with the majority leader, Senator Dole.

Senator Dole. I had forgotten I wasn't the chairman. That's why I was here first. [Laughter.]

It takes a while to break those habits.

I understand you have some family members here too, Jim. I think without the support of those family members, you probably wouldn't be here today.

Mr. Baker. There's no question about that.

Senator Dole. Would you like to introduce them for the record?

Mr. Baker. Yes, I would. My wife, Susan, is here; and my daughter, Elizabeth; my son, Will. And I have one more son coming. My son, Jamie, where is he? So three out of the eight are here.

The Chairman. Glad to have you all with us.

Senator Dole. I just have a couple of questions. There has been a lot of discussion about tax simplification, and I think everybody on this committee agrees that it's a great concept.

Some of us are just wondering what we should do first. It seems to many of us that deficit reduction has to be a priority. And I'm wondering if you have any views on these two very important areas.

Mr. Baker. Mr. Leader, my views are those of the President. And his views are that these are equal priorities for him on the domestic agenda. That is, tax fairness, tax simplification, on the one hand, and deficit reduction on the other.

He alluded to tax simplification in his inaugural address, and he will speak more to that in the state of the Union, as will he speak to deficit reduction.

It's his view that he would like to consider those as equal priorities. He would like to see them proceed on through the legislative process on separate tracks so that we don't get hung up in a negotiation on we will do this much spending, if you will accept this much by way of tax increases.

But in his mind, they are equal priorities.

Senator Dole. As I also understand, Secretary Regan has put forward a plan which he has indicated can certainly be modified. I know you have looked at that plan, but you have not yet adopted that as your plan. Is that correct?

Mr. Baker. That is correct. Nor has the President adopted the plan as his plan. I think it's our view that the Treasury study, the

Treasury plan, is simply a starting point on the road to reforming the tax system to make it more fair and more simple. And there are, as you suggested, elements in there that will have to be looked at very carefully.

Senator **Dole**. We discussed at great length, almost on a daily basis, the domestic deficit. And, of course, you will have some responsibility for the trade deficit. Is there any administration plan or program that will address what seems to be an ever-growing trade deficit?

Mr. **Baker**. Well, sir, we think that the trade deficit represents a serious problem as far as this country is concerned. You are perhaps familiar with the recent meeting that the President had with Prime Minister Nakosone out in California right after New Years. That is going to result in a round of new trade initiatives with Japan, which represents the largest part of our trade deficit. And we plan to push those vigorously.

We think that if we are successful in dealing with the budget deficit, and reduce the size of that deficit on the spending side, that that should hopefully help with the trade deficit because it should permit some reduction in the strength of the dollar.

Senator **Dole**. Do you think the Federal Reserve is basically on the right track? There is always some speculation in the media and even elsewhere that there is a constant tension between the White House, the Treasury, and Mr. Volcker.

Do you have any changes in mind for that relationship?

Mr. **Baker**. I suppose under our system, Mr. Leader, there are going to be tensions in that relationship as there have been going back through a number of administrations. It would be my hope that we could work—it's extremely important, I think, that the Federal Reserve and the Treasury work closely together, and in a cooperative way.

And it would be my hope that we could do that. And it would be my belief, based on contacts that I've had with the Chairman of the Federal Reserve, that we could do that.

Insofar as any structural changes in the relationship are concerned, I'm aware that there are some studies ongoing at the Treasury Department at a lower level. None of those have even come up to the secretarial level yet.

I have formed no opinion with respect to whether or not there ought to be changes in the relationship, except perhaps that the term of the Chairman of the Fed should be made coterminous with that of the President. But I think that the Chairman of the Fed himself advances that as something that we ought to do.

Senator **Dole**. Thank you.

The **Chairman**. Thank you, Senator Gramm, for coming this morning. We appreciate it.

Jim, you have been making the rounds talking to some Senators. I know they have raised the issue with you of effective dates and retroactivity and the argument has been made that because the Treasury plan is sort of hanging out there business is slowing down. Do you want to address yourself to that specific subject? What do you generally think about making tax changes retroactive?

Mr. **Baker**. Well, I think that there is a problem with respect to the Treasury plan, and the impact on investment decisions in some areas of business. Now I'm not sure how severe that is, Mr. Chairman.

We've heard at the White House from a lot of representatives of business that investment decisions are being delayed. And as a matter of fact, at the request of the White House, Treasury issued a statement just shortly before Christmas pointing out that there were very liberal transition rules and grandfathering provisions in the tax reform plan, and that they didn't want investment to be impeded in this way.

I think it's something that perhaps deserves a further look. And I have visited with a number of members of the committee about that. If I am confirmed, as soon as I'm in office over there, I would plan to take another look at that and see if there is something that should be done by way of a statement concerning retroactivity.

I suppose you have the Treasury statement or you can find it. It was December 19 in which—and I won't take your time by reading it here, but I have it here—in which the Secretary spoke to the problem, and tried to get the message out that there were going to be liberal transition rules and nobody was going to be affected by any dates that were set forth in the plan that were unduly harsh.

In other words, the Treasury had a very open mind with respect to that. I can read it for you, if you would like. Let me just read this part of the Secretary's statement—

> First, though, I want to make a statement that I hope will convey a message that needs to be heard far beyond the Hudson. We at Treasury took extreme care in the drafting of our proposal to ensure that no one would be penalized for making decisions based on current law. Accordingly, we have drafted extensive transition rules, including effective dates which would not significantly disrupt existing investments or current decisions regarding future investments. These dates are all shown in our report. We do not want any such disruptions to stem from our proposals and are sincerely interested in having brought to our attention any proposed effective date that can be shown to have such an effect. In summary, we want to ensure the transition to the modified flat tax proposal causes as little economic dislocation as possible, and we stand ready to modify any proposed effective date that is demonstrated to be unduly harsh.

So that statement is out there. It may not have received the distribution that it should have received.

The **Chairman**. Let me ask you about compliance. Whenever we get into the argument about spending cuts and budget savings and revenue increases, there is always a feeling we can get more money by better compliance. I'm not talking here about changing the laws to change liability. I'm talking about the enforcement of the laws to try to collect more money.

One of the arguments that is used—and I think probably with validity—is that if we add more agents to the Internal Revenue Service, we can do more audits and indeed we can collect more money, much more than the cost of the agents.

Do you have any view about that approach?

Mr. **Baker**. I have no reason to doubt that statement, Mr. Chairman. And that's the view of the Treasury Department, as I understand it. And we have in the mill right now, again as I understand it, proposals to add agents. I have no way of disproving that statement.

The CHAIRMAN. I think the statement is probably accurate. The question that comes up, I think, about IRS is they think of harassment and they are coming in and looking at your books. I haven't run across very many people who project income and outgo that dispute the statement that given more agents and more audits you get infinitely more money than the cost of the agents. The tradeoff is more Government agents, which some people don't want.

Mr. BAKER. I think that's correct. And I'm well aware of the public feeling out there with respect to the occasional instances where there is overzealousness on the part of IRS agents.

I suppose that if we have more agents, we can examine more returns, and we can catch more errors and pick up more revenue.

I'm not in a position to tell you whether the overzealousness is something that—exactly how extensive that is. I know it happens occasionally because I used to see it, quite frankly, in my practice of law.

I'm not sure, though, Mr. Chairman, that that argues that we should not have additional agents as required.

The CHAIRMAN. On any list of compliance that you get, one of the ones that shows up high is producing more revenue, and is, of course, withholding on dividends and interest. That is something that Senator Dole is well versed on.

Does the administration have any intention of taking another fly at that?

Mr. BAKER. I'm aware of no plans to take another fly at that. I think perhaps we learned a lesson together on that one. We didn't have the political muscle down there to support it, did we, Mr. Leader?

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Baker, many of us in the Congress feel very, very strongly that the single most important problem facing this country is the enormous Federal deficit. Doing something to reduce the deficit is a big step ahead of tax reform as far as priorities go.

My question to you is: Are you prepared to give us every bit of assistance and push and drive and lobbying, if you would, to really get these deficits down?

Mr. BAKER. Yes, sir.

Senator CHAFEE. We are going to need it. We are going to need every bit of help we can get. I think that you mentioned the doubled tracked procedure. I'm not sure you used those exact words, but I think you said there were two tracks, one for tax reform, and one for deficit reduction. We have only got so much energy, and I'm concerned that getting tangled up in the tax reform may divert our attention from the principal objective.

How would you envision the tax reform proposal coming along? As I understood what the President has said, he hasn't arrived at any conclusions as to whether to endorse the proposal. Obviously, you haven't arrived at conclusions. What would the schedule be, roughly, as you see it?

Mr. BAKER. Well, I don't know that I can give you a timeframe, Senator, but I would suggest that it's not totally unlike our experience in 1981 when we had a major budget initiative and we had a major tax initiative. And we found the resources to do both. And they represented the foundation of the President's domestic agenda in that year.

And we would hope that we would have the resources and ability to deal with both this year, not putting one ahead of the other.

Let me say this. The President views deficit reduction as every bit as important as anything else we have got to do. He happens to also believe that it's time that we brought fairness and perhaps more simplicity to our tax system, if we can do it.

It's a major undertaking. We don't minimize that. We recognize that. I know you are all hearing from various interest groups, and so are we, both at the White House and at Treasury.

Senator **CHAFEE**. One of the problems we hear most about is the elimination of the differential tax treatment for capital gains. Do you have any thoughts on that?

Mr. **BAKER**. Beyond saying that that's one I think we have to take a close look at, I have no specific thoughts, Senator. And I would say that there are probably others that some argue that have a detrimental effect on savings, investment, and capital formation.

We want to make sure that that's not the case before we proceed.

Senator **CHAFEE**. The leader mentioned to you problems with the trade deficit. Your answer to him, as I understood it, was that the way to solve the trade deficit principally is through getting rid of these budget deficits. I agree with that.

The administration has no suggestions on changing tariffs, do you? Increasing tariffs or anything like that?

Mr. **BAKER**. No, sir, we do not. I perhaps should add here that vigorous enforcement of the trade laws is an administration goal, an objective. And we would expect to continue to do that in addition to this initiative with Japan, and in addition to trying to reduce the deficit and thereby, hopefully, reduce to some degree the value of the dollar.

Senator **CHAFEE**. But you have no agenda for seeking any increases in tariffs?

Mr. **BAKER**. No, sir.

Senator **CHAFEE**. Thank you very much, Mr. Chairman.

The **CHAIRMAN**. Senator Long.

Senator **LONG**. Let me get back to the question I started to ask before, Mr. Secretary. I call you by that title because I think you will be the Secretary within a week, in any event. I hope it is sooner than that.

Donald Regan was the Secretary of the Treasury and a very strong man in the general scheme of things in this administration. He is moving over to take your old job. In fact, he is going to take the job you had as well as two other outstanding men in Government had.

He undoubtedly feels that he knows all the answers or most of the answers, about the Treasury job. My impression is that up to this point, whoever is Secretary of the Treasury speaks for the administration on tax matters—that if you talk to him, he has the right to make decisions. Of course the President has the final say, but generally speaking the President is going to go along with him.

I just wondered if the relationship between the Secretary of the Treasury, the Chief of Staff at the White House and the President is going to be the same or if it is going to be substantially different under this new arrangement.

Mr. **Baker**. I would suggest that it is going to be substantially the same, Senator. The Secretary and I were very close during the 4 years that I served as Chief of Staff. He was a part of the small group of us at the White House that formulated and tried to implement legislative strategy. I will continue to be a member of that group.

I don't think that there is going to be any problem from that standpoint. We worked extremely well together for 4 years and I'm quite confident, and I think he is too, that we will continue to work closely.

He's going to help me initially as I start out as Secretary of the Treasury, if you confirm me, and I'm going to help him as he starts out as Chief of Staff at the White House. And this is something that we both agreed to when this matter first came up.

Senator **Long**. Mr. Secretary, on an earlier occasion you tried to put together a bipartisan effort, to reduce the deficit, and I'm familiar with it because I sat with the group that you tried to put together to achieve something on that occasion.

In my judgment, that effort did not succeed because the House of Representatives—really the Speaker, but I think he was speaking for the more liberal Members over there—was just not willing to make any move at all insofar as Social Security was concerned at that time.

I hope you know that this effort didn't fail because any Senate Member was unwilling to cooperate. The problem came forward on the other side; not on the Senate side.

Mr. **Baker**. Yes, sir. I'm well aware of that.

Senator **Long**. I don't think the effort missed by a great deal even then. I think it came a lot closer to succeeding than most people realized—so much so that I think you would be well advised to try again to get a bipartisan group on any kind of basis to work with you.

Mr. **Baker**. Well, as I indicated in my opening statement, Senator, we think that both deficit reduction and tax reform, if they are going to succeed, have got to be done on a bipartisan basis. And I quite agree with you. I think the gang of 17 came pretty close to getting something done. And we did get hung up on the rocks of Social Security.

But there may be some way that we can emulate that process and do some good in the next 4 years.

Senator **Long**. You said that progress in reducing the budget deficit would help with the trade deficit. Did it ever occur to you that the reverse of that is also true?

Mr. **Baker**. Yes, sir.

Senator **Long**. In other words, if we will do things that will help with our trade accounts to save some of these jobs and put people back to work in basic industries, that will do us some good as far as our budget is concerned because we are lacking 3½ million good jobs out there because of this $140 billion trade deficit.

We have to try to turn that around. And I don't think you can do it just by negotiation, Mr. Secretary. I think you are going to have to treat them the way they have treaded us. I know how the Japanese did it to us. They just don't buy from us.

I believe at some point you are going to have to say to our trading partners that we have been generous as long as we can, but for a while we have got to be tough.

There was a previous Secretary of the Treasury from Texas. You recall very well who he was. He made a strong unilateral move when he was Secretary—I think that's the most impressive move I've ever seen by any Secretary of the Treasury in my experience—to say that we are going to straighten this mess out; we are not going to continue to run these huge deficits and to have people give us the worst of it; the United States is going to look after its own interest.

You are familiar with what he did along that line, I think.

Mr. **Baker**. Yes, sir.

Senator **Long**. I hope you would consider that at some point you are going to have to move, if you are going to get this mess straightened out. And mark my word, you are not going to negotiate your way out of that trap. You are just going to have to take action whether they like it or not. You just mark my word and see if I'm not right about that.

The Chairman. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Mr. Baker, you today, members of the committee, the President—there is hardly a public official who hasn't decried the deficit and wanted to deal with it. Many economists believe that one reason why continuing large deficits have not had a greater effect on interest rates is because it is being financed by foreign capital.

The Treasury has pursued recently an aggressive policy of increasing the sales of U.S. securities abroad. This has increased our Government's dependence on foreign capital to finance the deficit.

Do you see any danger in the Treasury's policy in this regard? Do you believe it's abetting the situation and do you contemplate or propose any change in that policy?

Mr. **Baker**. Senator, for the time being, I don't see any danger, if you are talking about the foreign targeted securities issues that the Treasury has advanced. And I think there have only been two of them. Obviously, there is some point beyond which you wouldn't want to go. I'm not prepared to tell you today that I know what that point would be.

I think that it is true that foreign ownership of the public debt is not as much today as it has been in the past, but I'm not so sure how meaningful that is when you consider how much foreign investment there is overall in the United States. But I have no plans to either increase the foreign targeted securities program over there or restrict it. I would have to get over there and look at it and see what the situation was.

Senator **Mitchell**. Reference has already been made to the merchandise trade deficit. As you know, over the last 4 years, the dollar has risen by as much as 40 percent against the currencies of our major trading partners. And that has resulted in the deterioriation, a marked deterioriation, of our relative trade position. It has caused our merchandise trade deficit to reach an all-time high of $130 billion last year. That is almost twice as high as the previous record in 1983, which in turn was twice as high as the record before that.

Do you believe the dollar is overvalued? And if so, do you think it appropriate for the Treasury to intervene in the international currency markets to try to deal with the problem?

Mr. **Baker**. I would rather say that the dollar is very, very strong, Senator. I think the term "overvalued" has a technical meaning. Since the value of the dollar is set by the market, I suppose one could argue it's not overvalued because it's set by the market.

It's obviously very, very strong. I do think there are some things that can be done to help with that situation, and I have already mentioned one of them, which is getting our fiscal deficit down so that we have less pressure on interest rates, and, therefore, perhaps less inclination to invest in the dollar.

I also think that it's in the interest of this country to encourage our trading partners to adopt those policies that we have adopted in this country which have given us the sustained economic growth that we are now enjoying. That is, freedom from overtaxation, freedom from overregulation. That if we can encourage our trading partners to adopt those policies, their economies will come back just like ours has. And that will help with the value of the dollar.

On the question of intervention, it's been the position of this Government as long as Ronald Reagan has been President that we would intervene only in instances of disorderly markets.

I understand that there have been some discussions in recent days between Secretary Regan and the finance ministers of Germany, Japan, Great Britain, and France looking toward the possibility of perhaps a little bit more activity in this area. Nothing has been done, as far as I know. And, quite frankly, I'm told that there are serious doubts about whether intervention today—whether or not intervention is effective in light of the vast amount of private capital that now flows out there in the exchange markets.

So I should not express, nor do I have, an opinion on whether our policy of intervening only where markets are disorderly should be changed. But that's obviously something that should be looked at because some will argue that that could have a dramatic effect on the value of the dollar.

Senator **Mitchell**. Well, it is a serious problem. As Senator Long suggested, we are seeing a steady drain of American manufacturing jobs going to other countries. And although the surge in imports across the board in this country has the beneficial effect of keeping inflation down, in the long run, I think we will be the losers because of this substantial loss of American manufacturing. We are, in effect, mortgaging ourselves overseas.

Mr. **Baker**. Could I say there, Senator, that you made mention of something that I perhaps should have said in answer to your question. And that is that the high dollar does have its benefits, and it does keep inflation down. And that tends to promote growth in this country and create jobs. And we have created, I think, 7.2 million new jobs in this country since the depths of the 1982 recession.

And I'm not arguing that that doesn't mean we should not take a look at the strength of the dollar.

Senator MITCHELL. During the previous administration inflation was high. But 10 million jobs were created. And I think that you have to balance the two against each other.

One of the very serious national social problems that we face is that in recent years both the economic downturns and upturns have had a geographic imbalance to them. The current recovery has not reached certain areas. And it's greatly aggravated by the problem you suggested. That while there are clearly benefits from the strong dollar, those benefits are increasingly localized in certain regions. At the same time, the adverse effects are felt in other regions so you have a very uneven economy in this country, which is not a good thing for our society as a whole.

Mr. BAKER. I agree.

Senator MITCHELL. Mr. Chairman, I have a number of other questions that I would like to submit in writing.

The CHAIRMAN. I wonder if I might do this. Senator Moynihan asked if there would be further rounds of questions, and, indeed, there will be. I would like to finish up the hearing today if we can, and run it straight through rather than adjourning at 12:15 or 12:30 and coming back at 2:30 or 3:00 and going through the afternoon. So we will go on as long as members want to ask questions.

And I hope, Jim, you are available to stay as long as we are going to go.

Mr. BAKER. I am.

The CHAIRMAN. Second, the majority leader has indicated he does not intend to try to rush this confirmation through on Thursday or Friday. So for those who want to see the transcript, the transcript will be available.

When we finish today, I would like, if the committee is willing, to report Jim Baker out so that we don't have to come back and have another markup for that sole purpose. But I assure the committee that there will be no effort to rush through hurriedly on the floor before people have a chance to review what has been said.

Next is Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Jim, I have four questions for you. I hope I can get them all in in 5 minutes, but it's going to take a lot of cooperation from you.

Mr. BAKER. You've got it.

Senator HEINZ. The first one has to do with Social Security, which is in the jurisdiction of this committee.

As you know, there has been talk among Republicans, and Democrats, in the Senate and in the House, about a budget freeze that includes a freeze on the Social Security COLA. My understanding is that the President says that he is opposed to anything that freezes or hurts Social Security beneficiaries. Other people say, no, his feet are not in concrete. Where is the President on the issue of Social Security?

Mr. BAKER. The President made a campaign commitment, Senator, with respect to Social Security that he would not do anything to reduce the benefits of Social Security.

Senator HEINZ. Is he in favor of freezing the Social Security COLA under any circumstances?

Mr. BAKER. No; he is not, therefore, as a result of his campaign statements, in favor of freezing it. Now he did say at his press conference the other night that if there was an overwhelming concensus up here on a bipartisan basis and it was sent down to him, he would obviously have to take a look at it.

Senator HEINZ. I think you have been very clear. You have been asked some questions about the Tax Code, and the reform that the Treasury Department has been working on. And, clearly, the goals of that reform are fairness and simplicity and economic efficiency.

I would hope that there is a fourth criteria that you consider equally important. That is, economic growth. Now to my view, economic growth in the United States with our free enterprise system and the jobs it creates is largely spurred by investment. And to take it one step further, that investment is spurred by savings. If there is not enough savings, interest rates go up, you don't have the money to invest, and you don't get the growth you want.

Can you guarantee us that any tax proposal you send us will do more to encourage savings than the opposite of savings, which is consumption?

Mr. BAKER. Well, I think that we are interested in encouraging savings. We are interested in encouraging investment. We are interested in not discouraging capital formation, Senator.

I can't guarantee you that you might look at a proposal that comes up and say this doesn't encourage savings to the extent I want it to.

Senator HEINZ. I'm not asking you to make an absolute pledge. I'm asking you whether you will make a pledge to have it encourage savings more than consumption. I don't ask you to say now it will do as much as any one of you up here want. That would be an impossibility.

Mr. BAKER. I think I could do that if by savings you mean savings and investment, and you don't draw a line between savings on the one hand and investment on the other.

Senator HEINZ. Well, I don't know how you get reasonable investment without a lot of savings. Let's go to my third question in the interest of time.

The subject is "indexing." I mentioned the freeze that is being talked about up here. Let's assume that the House and Senate do agree to some kind of an across-the-board freeze, presumably including the Defense Department in some way, shape or form, and that that budget freeze actually saves as much or more money in terms of deficit reduction than what the President proposes to us in his budget message on February 4.

Somebody is going to bring up the issue of freezing the indexation of the Tax Code, if we are going to freeze COLA's. How would you respond to somebody who says, well, if we are going to freeze pension benefit increases, COLA's, then we ought to freeze tax indexing for 1 year as well?

Mr. BAKER. I think the President has already spoken to that, Senator. And he has said on a number of occasions that he does not favor freezing indexing on the tax side. He would view that as a tax increase.

Senator HEINZ. The last question I have has to do with revenue raising but not tax increases. We've had over the past year or so a number of important hearings on the job of the Customs Service in policing against the diversion and other methods of bringing imports in without paying their fair share of existing duties, whether they are countervailing duties, antisubsidy duties—just the regular duties that certain countries pay because they haven't signed the subsidies code or they are not part of the GSP. And we are now 500 Customs agents short of where we were several years ago; 100 more have been authorized by the Congress. It is estimated that we could literally pick up over $1 billion in revenue net of the cost of those Customs agents per year.

And I want to know whether you are going to fill those slots or not.

Mr. BAKER. Well, if we can pick up that kind of money by adding those slots, I don't know why we wouldn't add those slots.

Senator HEINZ. Let me tell you why you didn't. You didn't because all the Cabinet members over the last year or two said to the President, as part of a team effort, we are going to freeze our personnel. In the Treasury Department what happened was more personnel, understandingly, were put into tax compliance. We want to get at the underground economy.

But if you freeze personnel overall, you increase it in the IRS compliance, you have to take it away from someplace else. They were taken away from Customs. While I understand the idea of freezing Government people—and there are certainly too many people onboard the Government—here, in this instance, I think you are really shorting that thing that you are going to hold dear; the revenue coming into the Treasury, in exactly the wrong way.

If my facts are correct, would you agree with my conclusion?

Mr. BAKER. If your facts are correct, I would agree that it's something that ought to be looked at.

Senator HEINZ. I thank you very much.

Mr. chairman, thank you.

The CHAIRMAN. Thank you. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would like to pursue a subject that Senator Mitchell was touching on. I suppose if there is one rule in government, it is that you never change just one thing. And that surely is true in the Tax Code.

We have been looking with great interest and real admiration at the three volume study on tax reform that the Treasury Department has produced. But one of the concerns that has emerged is: what would be its regional impact? Just as there has been a regional disparity in the economic growth patterns in recent years, that is attributable in some measure to tax policy, there are regional disparities in the impact of certain aspects of the Treasury proposals. The largest single revenue saving in the proposals comes from the elimination of the deduction of State and local taxes. The measure is projected to raise some $39 billion in 1988.

This change would have a particularly serious impact on the Northeast and Midwest. And the Northeast-Midwest Congressional Coalition House has taken a very strong view on this.

It has a second aspect. By eliminating the deduction for property taxes, there is an indirect impact, one of enormous scale, I would think, on education since property taxes overwhelmingly go to finance education They are school taxes, in effect.

Could you speak to that, Mr. Secretary, and tell us why you got into it and the degree to which you are committed to the specific proposals in that book?

Mr. **Baker**. Well, Senator, all I can say is what I have said before. And that is that the Treasury's plan is simply a starting point. And if there are problems in these areas, we are going to have to take a look at them.

I do think—and I agree with you that the largest single source of revenue, I think, in order to permit us to reduce all taxpayers' individual rates would come from the repeal of the deduction for State and local income taxes.

The Treasury tells me that we have a study—and I haven't seen it—that says that a median family of four in New York State ends up with reduced taxes under the Treasury plan notwithstanding the repeal of the State and local income tax deduction. That they are better off under the Treasury plan.

The taxing jurisdictions, I think, could be as well off if their tax is levied simply as a percentage of adjusted gross income because every taxpayer's adjusted gross income is going to increase as a result of the rate reduction.

So I think it remains to be seen maybe how——

Senator **Moynihan**. As we work through this, could we ask that we get some more specifics, because as you know, under the Treasury proposal, there is effectively a transfer of some of the present tax burden from individual to corporate income taxes.

Thank you for that. If we can just try to get our numbers straight and agree as much as we can, we will make a better decision, I hope.

I just want to ask you to volunteer something with respect to which you may not have a view. Since 1946 and the full Employment act, we have had at least two sources of economic views in the executive branch. There has been the Secretary of the Treasury and his Department, and there has been the Council of Economic Advisors. And they have produced equally important documents, and they have become part of an ongoing debate and exchange.

Could I ask if you have any view as a prospective Secretary of Treasury as to whether you would like to have those three gentleman or ladies over in the EOP keeping an eye on you and helping you out?

Mr. **Baker**. Well, as the President's Chief of Staff, Senator, I shouldn't have independent views with respect to a matter that he's currently considering. But let me tell you what the President has concluded.

The President has concluded that the Council serves a very valuable function and should be retained. And he plans to retain it. So there will be no more discussion or consideration of whether or not the Council will be moved or whether we would seek legislation to terminate it or anything like that.

Senator **Moynihan**. Mr. Chairman, I think the committee should welcome that fact, and thank Mr. Baker for finally settling it. That's an important institution and it's associated with an important public goal. And thank you for settling it, sir.

Mr. **Baker**. Yes, sir.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman.

Mr. Secretary, many of the Senators on this committee have asked you questions concerning our trade deficit. And you responded to those questions.

I'm a little concerned, though, about the administration's position, at least as you described. Let me explain why. When the trade issue was first raised by Senator Dole, you mentioned the President's meeting with Prime Minister Nakasone as an initiative to try to reduce the trade imbalance with Japan.

Last week, I was in Japan, and I talked with Prime Minister Nakasone, as did Senator Roth. And I can tell you that Japan is not moving with full speed, in my judgment, to reducing the trade barriers in the areas that were on the Prime Minister's and the President's agenda; namely, telecommunications, pharmaceuticals, and, particularly, processed forest products.

My point really is this. Even if Japan does open up its barriers entirely to American products, that will reduce the trade imbalance with Japan by only $7, $8, $10 billion. The trade imbalance with Japan will still be about $20 billion.

Worse yet, the imbalance with Japan is only a small portion of the total in trade imbalance that United States has with other countries, which is about $130 to $140 billion.

My point really is that we in America have to do more to meet the challenge of international trade than the few things you mentioned in your opening statement. We have to meet the challenge very aggressively. And I think more aggressively than this administration realizes.

And I'm wondering the degree to which the administration does have specific policy initiatives in order to redress the imbalance.

I want to remind you that our country continually had trade surpluses from about 1893, for about three-quarters of a century, until about 1975, the first year in which we began to run a deficit. And we've had deficits growing since then.

Mr. **Baker**. Could I suggest that the last surplus was the year that I was Under Secretary of Commerce, Senator? [Laughter.]

Senator **Baucus**. You must have a lot of good ideas, then. I'd like to know what those ideas are.

Mr. **Baker**. Well, I mentioned a number of things that I thought should be done, and that we are going to try and do.

First, I suppose, I should say that this administration is dead set against returning to a policy of protectionism.

Senator **Baucus**. I appreciate that.

Mr. **Baker**. And you agree. And that's a two-way street that we don't want to start down.

As far as Japan is concerned, in addition to the initiative that you referred to in those three areas—and I do believe that we can be hopeful that there will be some progress in the near-term, Senator. And we have an under secretarial delegation on the way over there in a few days.

We have made considerable progress, we think, with the Japanese in terms of removing some of their controls from the yen and letting the yen become a bit more of an international currency, which should help it against the dollar and which should have some beneficial effect on our trade deficit with Japan.

We've got to continue to vigorously enforce the trade laws of this country—countervailing duties and dumping laws. We have got to continue to protect against surging of imports as we did here not long ago with respect to the steel industry.

The administration is looking at the possibility of—and the President has not made a decision on this—of trade reorganization involving the Department of Commerce and the Office of the Special Trade Representative. No decision has been made there.

The problem is a very serious one. In the long-term, we have got to encourage policies in those countries that are our trading partners that will permit their economies to grow so that they will be good trading partners of ours and we won't run these deficits.

Senator **BAUCUS**. I just encourage you again to look at this whole question once more and find something that is more aggressive, more definite. It's a severe problem.

Mr. **BAKER**. It is a serious problem.

Senator **BAUCUS**. I have a second line of questions. Lately, the President's aides have begun talking about deficit reduction goals in terms of trimming about $50 billion from fiscal year 1986. It seems to imply an abandonment of the goal of reducing the deficit to 2 percent of GNP by fiscal 1988.

Is the administration still pursuing that goal of 2 percent?

Mr. **BAKER**. Yes, sir, Senator. The President hasn't abandoned that as a goal. He hasn't abandoned 4 percent in fiscal 1986 as a goal either. He may be a little bit short, but he is going to submit a budget to the Congress which will call for an overall program spending freeze of fiscal 1986 over fiscal 1985, and which will result in some $49.5 to $50 billion in outlay reductions from the baseline.

Senator **BAUCUS**. But that proposal will also contemplate reaching the 2 percent goal by 1988?

Mr. **BAKER**. That will be the goal. Whether or not we actually met to the 2 percent—I think we will get close, but we may not quite make the 2 percent.

Senator **BAUCUS**. Thank you.

The **CHAIRMAN**. Senator Boren.

Mr. **BAKER**. Excuse me. But that's still being worked on down there, Senator, so I don't have the final numbers.

Senator **BOREN**. Thank you, Mr. Chairman.

I want to join with others who earlier expressed their pleasure that a person of your ability would be willing to serve as Secretary of the Treasury. I think we are fortunate to have you willing to serve in that capacity.

I was also pleased to hear you say a few minutes ago that, in general, you understood the dangers of applying tax changes retroactively. And as I discussed with you the other day, and you were very sensitive to it, these proposals have already had a chilling effect particularly in the independent producer sector in the oil and gas industry, for those small companies that have to go to outside investors to raise funds.

And, again, I would encourage you to examine to see if there are any further ways that we could be reassuring about retroactivity so that it will not involve a further decline in confidence and business activity.

We've had a recent study that indicates the rig count in our State may be some 100 lower today just because of the talk, the chilling effect of the talk of these major changes.

I would like to ask you—and, again, I was reassured that you said that we were not locked in at this point on every single provision of this tax proposal from Treasury. That each one would be examined as we go along.

In particular, would you be sensitive to the impact that various parts of the plan could have on key industries vital to our national security. And it will come as no surprise to you that as a Senator from Oklahoma I am, of course, concerned about the potential impact of doing away with intangible drilling deductions, depletion and other things on the independent sector.

I want to put in the record at this point a summary of the findings from the Interstate Oil Compact study which indicates we could lose some 90,000 jobs and over $800 million a year in income in that sector in my State alone, if these provisions were adopted without change.

[The information from Senator Boren follows:]

IMPACT OF TREASURY'S PROPOSED TAX CHANGES

Nationally the repeal of the expensing of intangible drilling costs would have a devastating effect. Specifically we can expect:

- the loss of 630,000 jobs annually from 1986-1991
- the loss of 838,000 barrels/day annually
- the loss of $6 billion in annual oil and gas revenues
- the loss of $ 360 million in annual severance taxes
- the loss of 6 billion barrels of undiscovered oil from 1986-91
- the loss of 203,000 wells never drilled

In Oklahoma the impact will be greater ~~do~~ due to the concentration of the industry . Specifically we can expect:

- the loss of 92,841 jobs annually from 1986 to 1991 (7% of the total workforce 1 counting only those directly related jobs)
- the loss of 123,000 barrels/day annually
- the loss of $885 million in annual oil and gas revenues
- the loss of $63 million in annual severance taxes
- the loss of 928 million barrels of undiscovered oil 1986-91
- the loss of 25,000 wells never drilled

All of the above will occur with the repeal of the expensing of intangible drilling costs. Should the additional impact of the repeal of the oil depletion allowance be considered Oklahoma would suffer accordingly:

- the loss of 6,445 stripper wells in the first year alone
- the loss of 150 million barrels of oil reserves
- the loss of 18,250 jobs
- the loss of $147 million in oil revenues annually
- the loss of $22 million in royalty payments annually
- the loss of $10.4 million in severance tax payments annually
    - * these figures are in addition to the above mentioned numbers

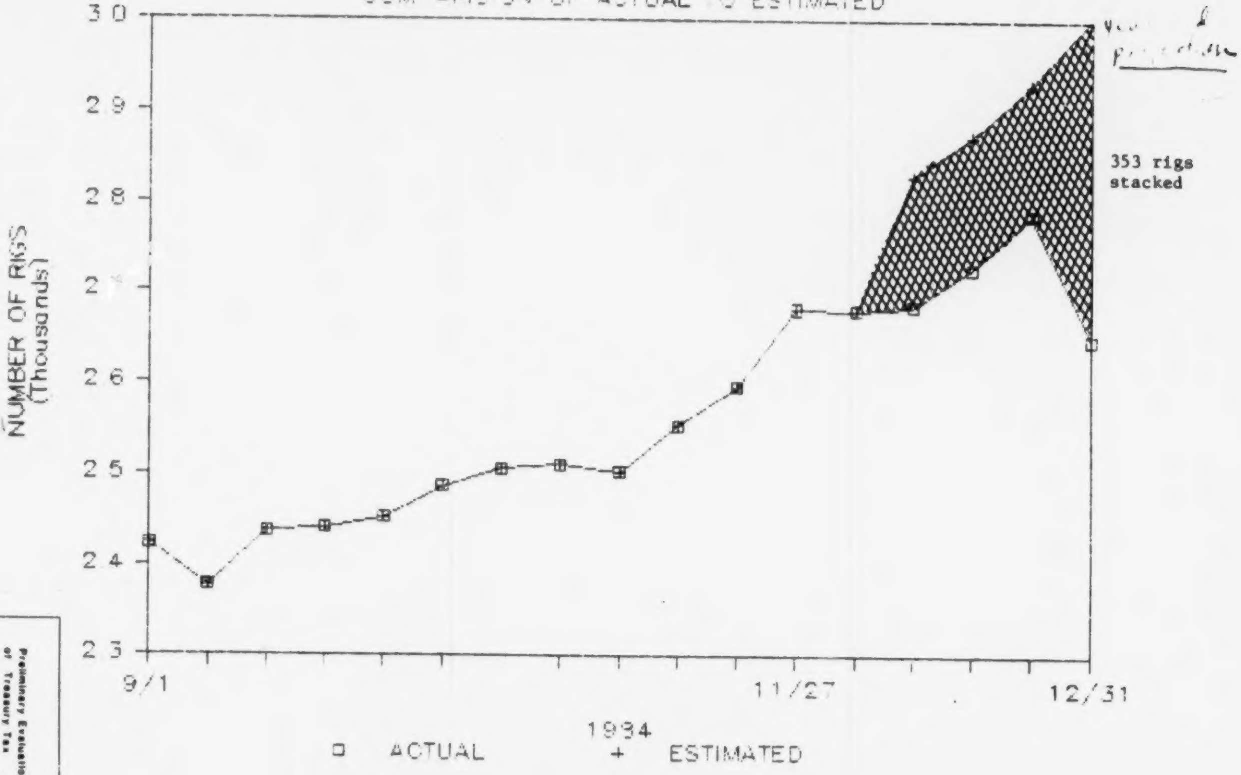
These numbers have been compiled by the Interstate Oil Compact Commission and are conservative in their estimation.

RIG

COMPARISION OF OKLAHOMA & NATIONAL DRILLING RIG ACTIVITY AFTER TREASURY SECRETARY REGAN'S NOVEMBER 27, 1984 TAX PROPOSALS AFFECTING DEPLETION & INTANGIBLE DRILLING COST TAX TREATMENT BASED ON 1983 & 1984 YEAR END ACTIVITY

DATE	NATIONAL ACTUAL 1983	NATIONAL ACTUAL 1984	NATIONAL ESTIMATED* 1984	NATIONAL DIFFERENCE 1984	TEXAS ACTUAL 1983	TEXAS ACTUAL 1984	TEXAS ESTIMATED* 1984	TEXAS DIFFERENCE 1984	OKLAHOMA ACTUAL 1983	OKLAHOMA ACTUAL 1984	OKLAHOMA ESTIMATED* 1984	OKLAHOMA DIFFERENCE 1984
9.1 248	2210	2424	2424	0	805	811	811	0	261	278	278	0
255	2247	2377	2377	0	827	805	805	0	253	281	281	0
262	2280	2436	2436	0	849	828	828	0	253	294	294	0
269	2265	2441	2441	0	857	833	833	0	248	286	286	0
276	2312	2452	2452	0	857	862	862	0	253	280	280	0
283	2387	2487	2487	0	871	852	852	0	264	284	284	0
290	2383	2506	2506	0	876	844	844	0	263	305	305	0
297	2418	2511	2511	0	886	860	860	0	250	311	311	0
304	2409	2503	2503	0	879	863	863	0	247	307	307	0
311	2473	2554	2554	0	878	856	856	0	255	308	308	0
318	2556	2597	2597	0	917	878	878	0	289	318	318	0
325	2593	2683	2683	0	932	891	891	0	305	332	332	0
11.27 332	2667(a)	2682(b)	2682(c)	0	934	944	944	0	332	326	326	0
339	2704	2686	2830(d)	144	950	920	930	10	342	328	385	57
346	2746	2728	2874	146	967	938	946	8	355	326	400	74
353	2800	2787	2930	143	979	953	958	5	376	352	423	71
360	2870	2650	3003	353	977	917	956	39	418	309	471	162

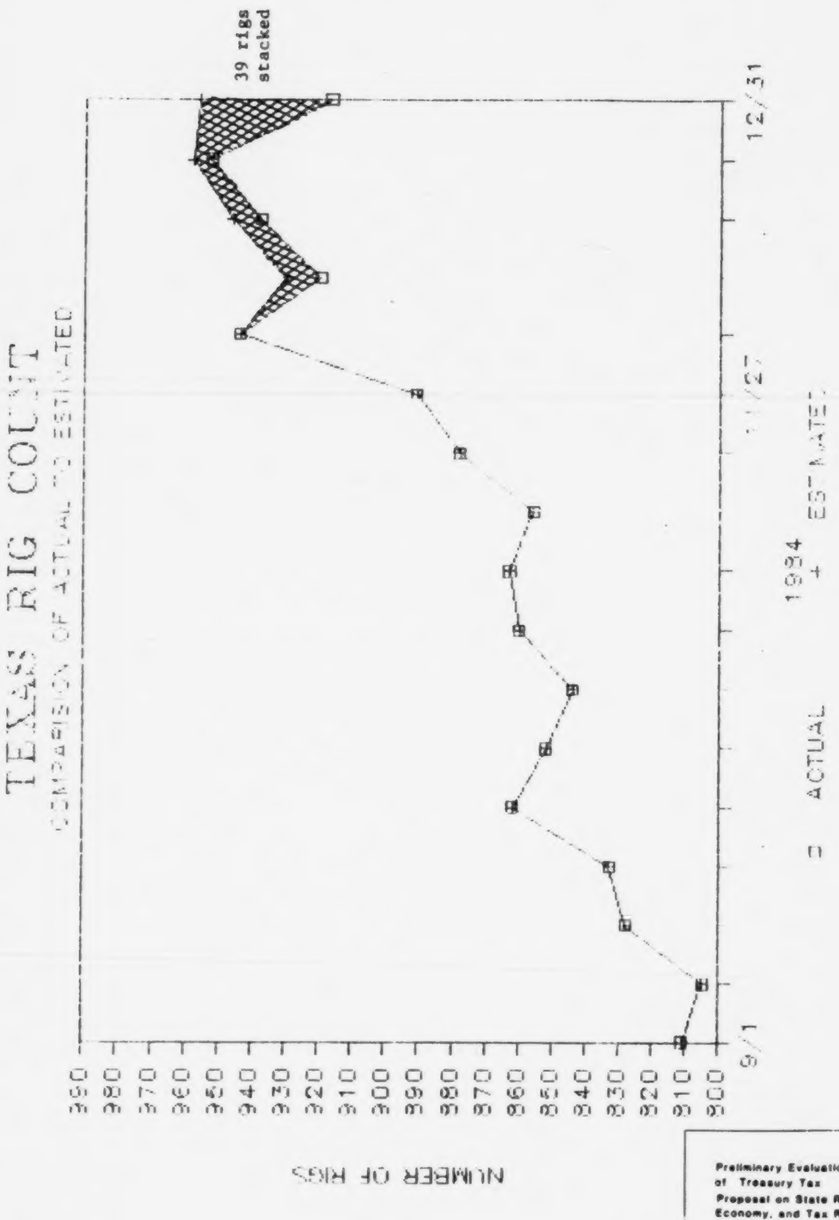
NOTE: * BASED ON 1983 RIG COUNT TRENDLINES AFTER NOVEMBER 27, 1984.



NATIONAL RIG COUNT

COMPARISION OF ACTUAL TO ESTIMATED

Preliminary Evaluation
of Treasury Tax
Proposal on State Resources,
Economy, and Tax Revenues
January 8, 1985



Preliminary Evaluation of Treasury Tax Proposal on State Resources, Economy, and Tax Revenues
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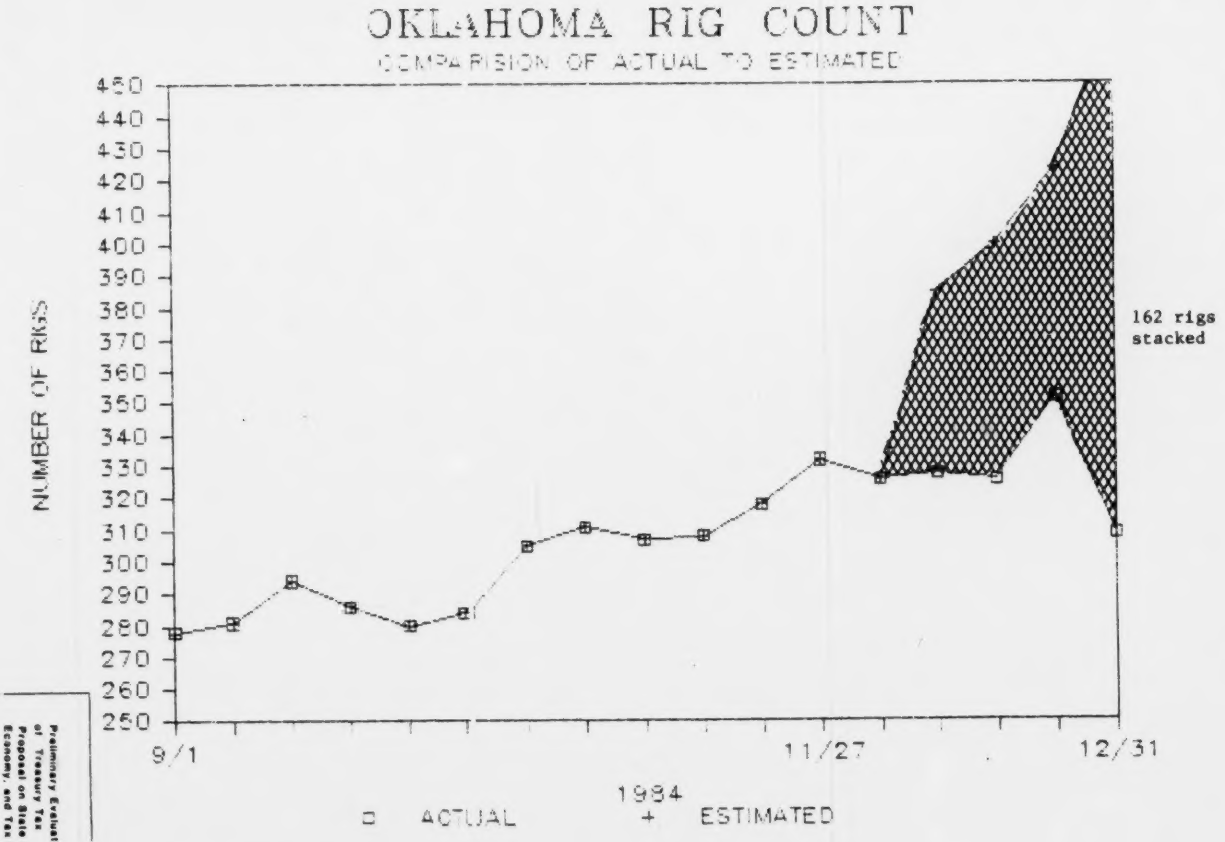

OKLAHOMA RIG COUNT

COMPARISION OF ACTUAL TO ESTIMATED

Preliminary Evaluation
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Proposal on State Resources,
Economy, and Tax Revenues
January 8, 1985

COMPARISION OF OKLAHOMA & NATIONAL DRILLING RIG ACTIVITY
AFTER TREASURY SECRETARY REGAN'S NOVEMBER 27, 1984 TAX PROPOSALS
AFFECTING DEPLETION & INTANGIBLE DRILLING COST
TAX TREATMENT BASED ON 1983 & 1994 YEAR END ACTIVITY

DATE	NATIONAL ACTUAL 1983	NATIONAL ACTUAL 1984	NATIONAL ESTIMATED* 1984	NATIONAL DIFFERENCE 1984	TEXAS ACTUAL 1983	TEXAS ACTUAL 1984	TEXAS ESTIMATED* 1984	TEXAS DIFFERENCE 1984	OKLAHOMA ACTUAL 1983	OKLAHOMA ACTUAL 1984	OKLAHOMA ESTIMATED* 1984	OKLAHOMA DIFFERENCE 1984
9-1 246	2210	2424	2424	0	805	811	811	0	261	278	278	0
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269	2269	2441	2441	0	857	833	833	0	248	286	286	0
276	2312	2452	2452	0	857	862	862	0	253	260	260	0
283	2387	2487	2487	0	871	852	852	0	264	284	284	0
290	2383	2506	2506	0	876	844	844	0	263	305	305	0
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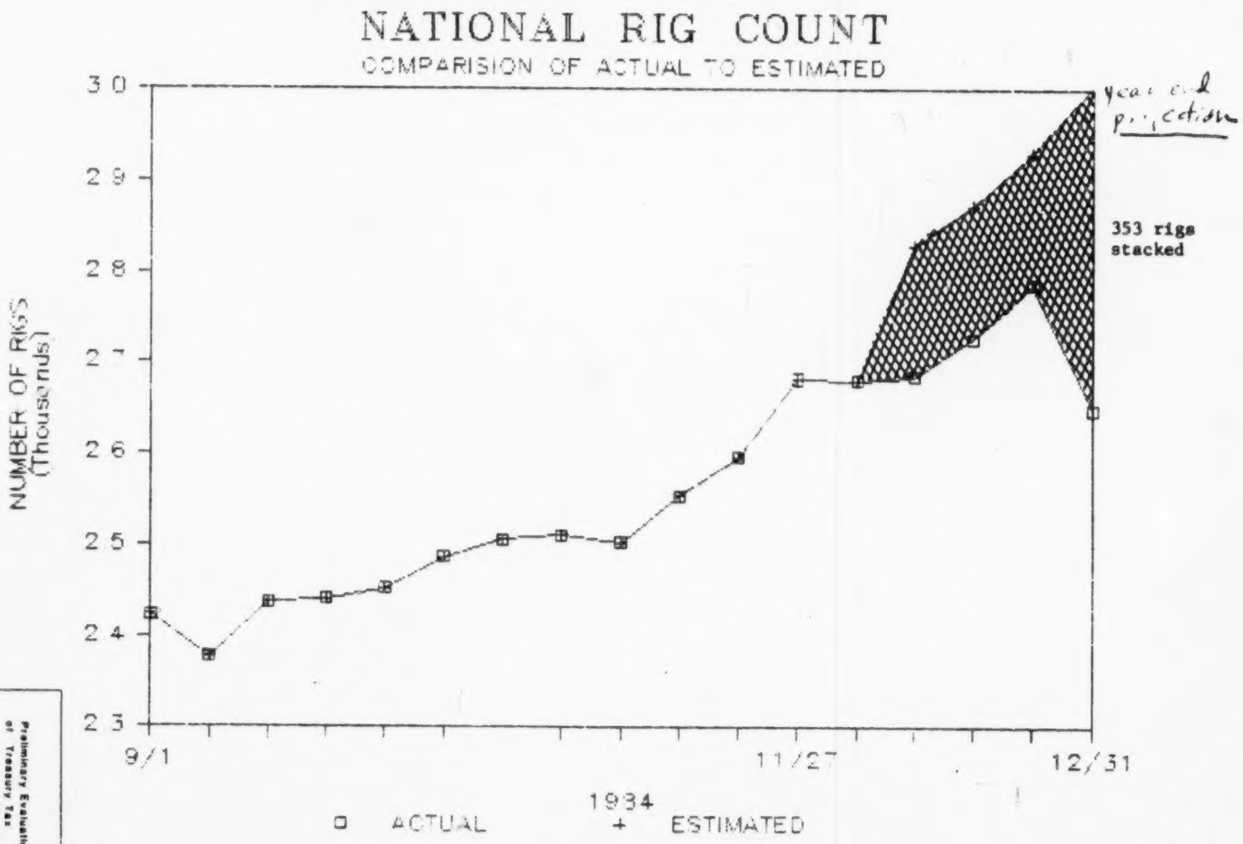
NOTE: * BASED ON 1983 RIG COUNT TRENDLINES AFTER NOVEMBER 27, 1984.



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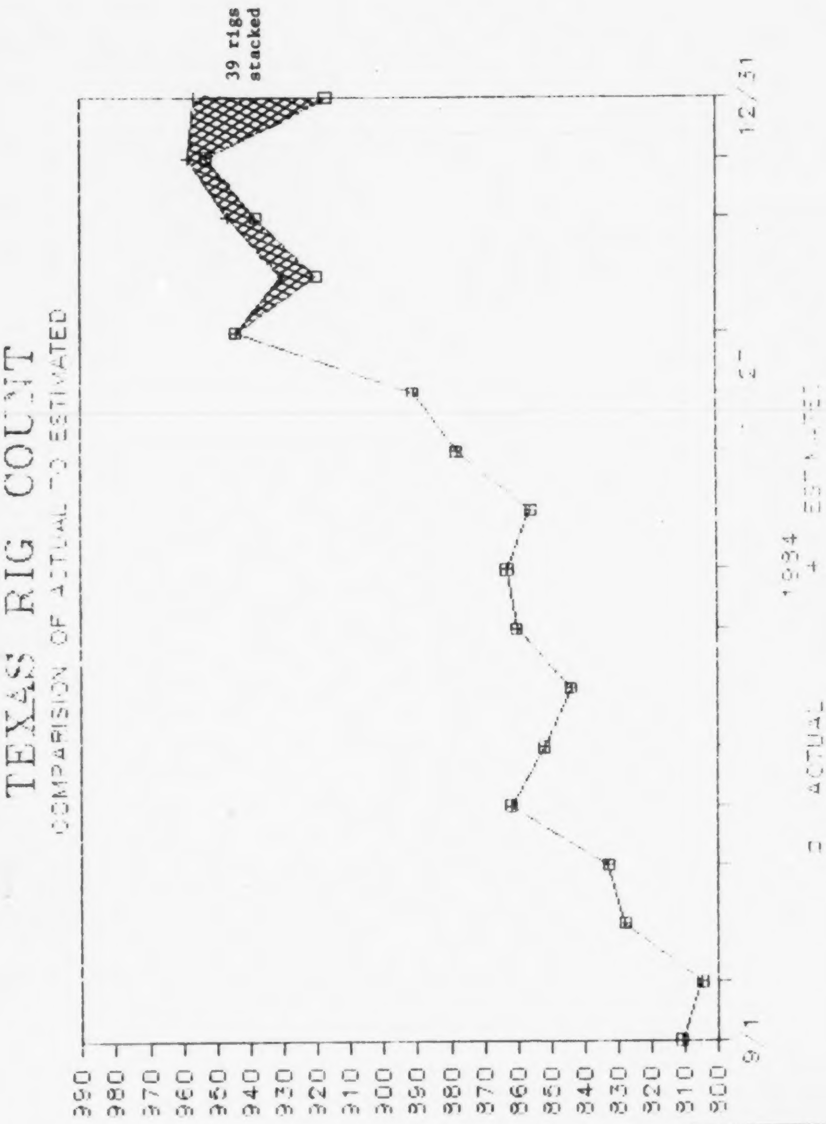

39 rigs stacked

Preliminary Evaluation
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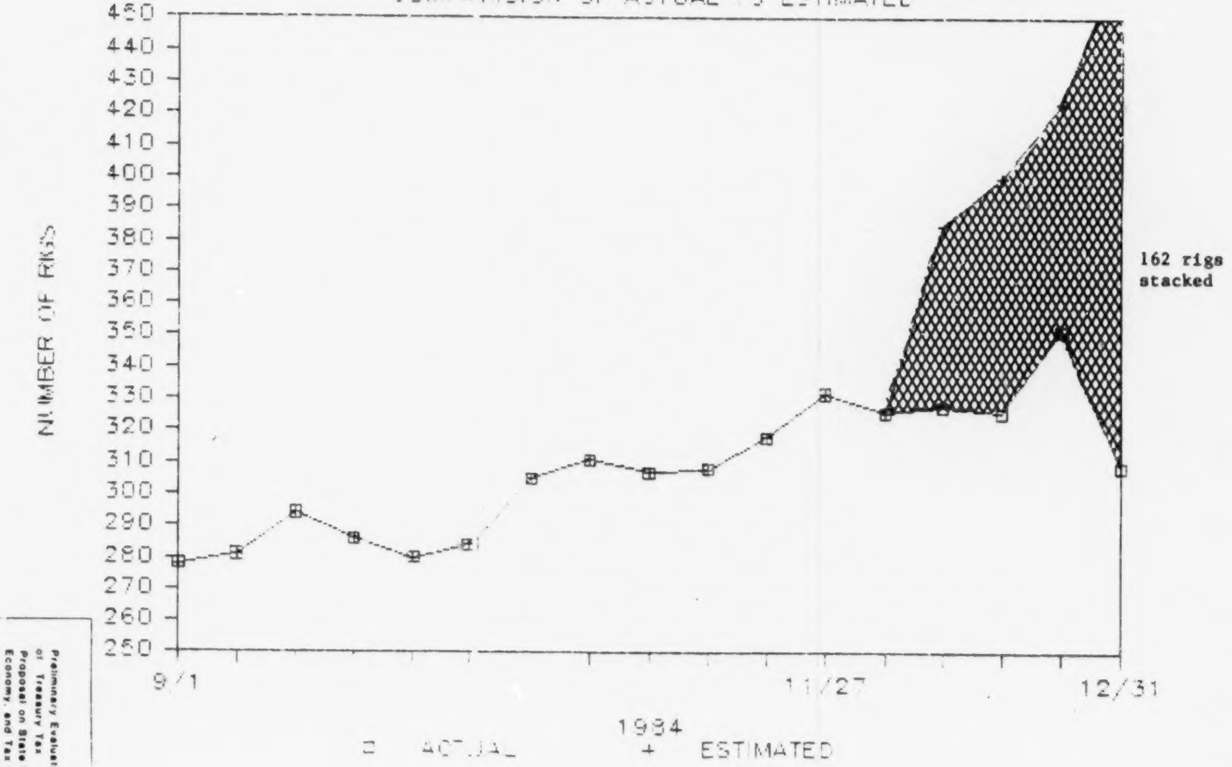
January 8, 1985

OKLAHOMA RIG COUNT

COMPARISION OF ACTUAL TO ESTIMATED



Preliminary Evaluation
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Senator **Boren**. But be it the oil and gas industry or other sectors, will you be particularly sensitive to see that we do not by any of these provisions have such a devastating effect on any particular industries that are key to our national security that the whole security could be impacted? It's not just the domestic energy industry but there are several others that at least maintaining a modicum in those industries domestically is very important to our national security.

Mr. **Baker**. Well, clearly, Senator, national security considerations have to enter into any undertaking such as this. And I happen to be one who believes that the domestic energy industry—that it's vital to our national security that we have a viable domestic energy industry.

At the same time, I think the Treasury position with respect to this plan that has been adopted to date is eminently reasonable. And that is simply if you say that these are going to be the effects, let us see your evidence. Bring it in. We will look at it.

Senator **Boren**. The data would be examined and considered if we can demonstrate that—after you studied the methodology used—that some of the results of these studies might in effect be correct.

Mr. **Baker**. Absolutely.

Senator **Boren**. Let me also ask this. There had been a rumor circulating—and those of us from my part of the country are pleased with your understanding and knowledge of industries like agriculture, domestic energy production and others—there has been a rumor circulating that you might decline to even weigh in on the broad policy considerations in areas like energy policy. And as you have done at times in the past as an adviser to the President. And I understand that this is certainly not a necessary policy on your part in the past because your holdings are in a blind trust and that you could provide that expertise.

I personally hope that you will provide all the expertise that you have. I think we would be deprived just as if we didn't allow the Secretary of Agriculture to comment if he were a farmer on agricultural policy, if you were not allowed to comment and weigh in on the debate in terms of tax policy on things like agriculture, energy and other areas where you have a knowledge yourself.

I wonder if you would comment as to whether or not you would be an active participant in policy discussions at least broadly on all of these areas.

Mr. **Baker**. Senator, I executed a qualified blind trust when I entered Government on January 20, 1981. And that trust has been in continued existence since then; approved by the Office of Government Ethics and everybody else that has to approve those things.

So I don't know anymore what I own. I suppose I have constructive knowledge of what went in there originally. I'm told by counsel for the Treasury Department, counsel for the White House and the Office of Government Ethics that I'm not foreclosed from making broad generic policy determinations with respect to energy matters.

And you are quite right that I did recuse myself from those things while I was at the White House but it was done as a purely voluntary thing on my part. I had just come into Government. At that time, I had some energy assets. My responsibilities as Chief of Staff at the White House were so broad that any number of things could come through, come across the desk, and I would have to spend a lot of time deciding "Do I have to recuse myself here?" and that sort of thing.

As Secretary of the Treasury, I'm advised by these three counsel that I can consider broad generic policy matters. I would expect to do that. I would expect to recuse myself or such a waiver as permitted by law with respect to specific or particular matters that I full might constitute a conflict.

Senator **Boren**. Thank you very much.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Mr. Baker, I would like to welcome you and tell you that you follow in some pretty big footsteps. I think that Secretary Regan did an outstanding job. But I feel confident, based upon what you have said so far in our conversations, that you will do an equally outstanding job.

One of the major things that you will have to deal with—and you have already commented on that today—is the whole emphasis on tax reform as well as deficit reduction. You said that the ultimate plan that would be submitted would be developed over the next several months, and that you hoped that there could be action completed as in 1981 by the August recess. Is that correct?

Mr. **Baker**. Yes, sir, Senator, I declined to put a specific date on it. But in response to the question, do we have enough resources to deal both with the deficit reduction and tax simplification at the same time, my answer to that would be, yes, as we did in 1981.

I really would not want to put a date on it because I'm aware of the magnitude of this undertaking.

Senator **Bradley**. When you develop a package on tax reform, it would be helpful, I think, to know if the administration intends to meet certain principles. I'd like to know whether you agree or disagree with these principles. Do you agree that any eventual package should not increase the budget deficit?

Mr. **Baker**. Yes.

Senator **Bradley**. Do you agree that any eventual package should not increase the relative tax burden on middle- or low-income people?

Mr. **Baker**. Yes, sir.

Senator **Bradley**. Do you agree that any tax package should provide the lowest possible tax rate for the greatest number of Americans?

Mr. **Baker**. Consistent with considerations, Senator, of stimulating savings, investment, and capital formation. Yes.

Senator **Bradley**. Now the Treasury proposal has an increase in taxes on corporations, and a cut in taxes for individuals. Do you agree with that?

Mr. **Baker**. Well, I cannot——

Senator **Bradley**. Not in specific terms, but the principle.

Mr. **Baker**. Well, I don't disagree that there may be—let me put it this way. If we are going to make the code more fair, and if we are going to simplify it, that may be a necessary result. But I don't want to be understood as embracing it to the extent and degree that it is done in the plan that has been submitted.

Senator **Bradley**. But in principle, that would be the result? Maybe not the same amount.

Mr. **Baker**. If you are going to reduce everybody's rates, you've got to do two things. You've got to take a very careful look at special preferences and deductions and you have got to include income that is now not being taxed, both corporate income and individual income.

Senator **Bradley**. Shifting gears a little bit——

Mr. **Baker**. May I just volunteer one more thing?

Senator **Bradley**. Sure.

Mr. **Baker**. Maybe I ought not to do this, but you asked me if one of the things I agreed with was that the deficit should not be increased. And I said "yes." I might also say that I might suggest that it's the President's position that the plan should be revenue neutral.

Senator **Bradley**. Yes.

Mr. **Baker**. That is, operating both ways.

Senator **Bradley**. Yes.

There are some economists who argue that the existence of the U.S. deficit over the last 3 years, given the underutilization of capacity internationally of productive resources and high unemployment worldwide, that that deficit has been the only thing that has kept the world out of serious depression. Do you agree with that?

Mr. **Baker**. I can't express an opinion on that, Senator. I just don't know.

Senator **Bradley**. Do you believe that the dollar is too high or do you think it should come down?

Mr. **Baker**. I think the dollar is very, very strong. And as I said in answer to a prior question, I think there are pluses and minuses with respect to that strength of the dollar. And it's not a case of too high or too low. I think we have to look at the consequences of moving it down or permitting it to continue upward.

Senator **Bradley**. There were a number of questions relating to the trade deficit. In particular, the Japanese trade deficit. Is it not true that the Japanese are major exporters of Japanese capital into the United States?

Mr. **Baker**. Yes.

Senator **Bradley**. So that when we consider the deficit, we consider not just the trade deficit but also the capital accounts, deficit or surplus, in order to get a true picture?

Mr. **Baker**. That's correct.

The Chairman. Senator Danforth.

Senator **Danforth**. Mr. Chairman, thank you very much.

Mr. Baker, first let me express, along with other Senators, my admiration for you. Next to my admiration for your wife, you are one of my heroes in Washington, and I'm delighted you are willing to take this job.

Mr. Baker, you have stated your very strong interest in tax simplification. And that is to be one of the key priorities of the administration in the President's second term. And one thing that you are going to be working on in the Treasury is that.

The way you have explained it, at least in your statement and as I have heard you speaking not only today but at other times as well, is that tax simplification is viewed as an equal priority with deficit reduction. And then reading your statement today, you talk about making the Tax Code fairer and simpler, and you also talk about increasing incentives for savings and investment.

Now it would be wonderful if we could do everything at the same time. It would be wonderful if we could reduce the deficit, if we could make the Tax Code fairer and simpler, if we could provide incentives for savings and investments.

My question to you is: Let's suppose that's not possible. Let's suppose that there is natural conflict between the various things that you would like to have as priorities.

Senator Chafee said earlier that it was his view that reducing the size of the deficit is the No. 1 priority. That happens to be my view as well, and I think that that is the prevailing view of the Senate.

Can you assure us that the administration's program for tax simplification will not somehow muscle out deficit reductions?

Mr. BAKER. Yes, sir.

Senator DANFORTH. And that as far as we are concerned and in setting time priorities and scheduling the Senate and so on, can you assure us that at least sequentially a deficit reduction will be the No. 1 objective of the administration?

Mr. BAKER. The scheduling up here, Senator, is not something that we would be controlling from down there. I can assure you that efforts to make the tax system more fair and more simple will not muscle aside in terms of priority our efforts to deal with the deficit. But they are equal priorities as far as the President is concerned. We wouldn't want the reverse to be true either. And that is that we would have to put tax simplification on the back burner until we had dealt with the deficit.

Senator DANFORTH. I understand your desire. If it turned out—and as I read the morning paper, Speaker O'Neill has expressed concern that tax simplification will somehow muscle out or shove aside the No. 1 priority, which is deficit reduction. And it's my understanding of your view that that will not happen.

Mr. BAKER. We are not seeking that, Senator. We would like to move them as we have suggested before as equal priorities on separate tracks.

Senator DANFORTH. Now let us suppose that the tax simplification turns out to clash with some other things that we would like to do. For example, capital formation, incentives for savings, and investments that are mentioned in your statement. Then what?

Mr. BAKER. I hope I have already alluded to that this morning. And that is we would want to take a look at this plan in detail to see whether or not it had detrimental effects with respect to savings and investment and capital formation, and where there were elements of it that did so, we would want to seek to revise those or change those in some way.

Senator DANFORTH. Good.

Now how about charitable contributions? A number of people in the charity field, college presidents and so on have already stated a concern that tax simplification, for a couple of reasons, means reduced charitable contributions.

One, because the rate is lower, and, therefore, the value of any tax preference is less. And, two, because you are placing more restrictions on charitable contributions themselves.

Supposing it were clear that the administration's program would lead to a major reduction in contributions to colleges and universities and the Red Cross and churches and so forth? Would you also be willing to look at that and adjust your program to meet that problem?

Mr. BAKER. We certainly would, Senator. And as I understand it, the Treasury Department is hearing from people right now who have that concern, and is taking a look at the data.

Let me say this once again. It's the President's view and our view that if there is some way on a bipartisan basis that we can find to make this tax system of ours more fair and more simple, we will engender respect not only for the tax system on the part of the Amercian people, but respect for government generally.

Senator DANFORTH. Right. I understand. And nobody can be against tax simplification unless the byproduct of tax simplification is havoc in either the business community or the people who are involved in charities and so on.

Mr. BAKER. We don't seek that.

Senator DANFORTH. Finally, Mr. Secretary, I was very pleased to hear you confirm something else that I have heard before. And that is that the question of trade reorganization is an open question now in the administration. I happen to disagree with Senator Roth on this subject. I think that the idea of the Department of Trade is kind of crazy. [Laughter.]

And, therefore, this is one crazy idea that I don't support. I have supported some crazy ideas. [Laughter.]

This is one I don't. And I would hope that the new Secretary of the Treasury might add his voice to those who feel that this would be contrary to our interests in international trade.

Will you? [Laughter.]

Mr. BAKER. You don't want me to prejudge that, do you? [Laughter.]

Senator DANFORTH. I do, but I won't push if the prejudgment isn't coming my way.

Mr. BAKER. My advice on that has got to come to the President from me as Chief of Staff, since that's a current matter we are discussing.

The CHAIRMAN. I think this is a good time for Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman. I want to tell Mr. Baker that although I wasn't here when the opening statements were made, but I do have an opening statement that I will enter in the record which recognizes your high qualifications for the office to which you have been appointed. I particularly would like to applaud your willingness to continue to serve the public and our good President, considering that your remuneration in private life would be so much greater. We should be thankful that we have people like you who are willing to donate their efforts to good Government. I commend your willingness to continue serving the administration.

I would like to recall for all of those who may not remember, that when we had Secretary Regan here 4 years ago for his confirmation hearing, many of us who were freshmen at that time, were focusing on the whole issue of how committed the President was to a balanced budget. We were worried about whether or not we were going to have a $40 billion deficit, or a balanced budget at the end of the first term. Later I remember, even as a member of the Budget Committee, voting against a budget resolution that had a $40 billion deficit in it. All of us would like to have that budget situation again, so we would be talking about $40 billion deficits, instead of what we are now. On the other hand, a lot that has happened in the last 4 years was unpredictable 4 years ago, when Secretary Regan was going through his confirmation proceedings. I am satisfied, from my years of knowing you, and working with you over the last 4 years, of your commitment to getting that deficit down, as difficult as that may be. You have reaffirmed your continued commitment to that objective in your role as the Secretary of the Treasury. In your role as an adviser to the President, I appreciated that commitment, and probably appreciate it now, more than ever. Considering how difficult it is to change the direction of a train out of control, I would just say, do the best you can, and we will turn this around.

I would also ask, now that you and Secretary Regan are changing positions, will he be the President's major economic adviser and spokesman on economic issues. In the past I assume he did that as Secretary of the Treasury. He worked closely with the President.

How does his role change? And do you assume the position of being the chief economic spokesman for the administration, or does Secretary Regan still retain that?

Mr. **Baker**. It is intended, Senator, that I will assume that role, and the President said that in his announcement of the switch. It is also intended that Secretary Regan will become the President's chief legislative strategist and Chief of Staff and all the things that come with that job. I mean, it is a complete job switch, as I said in answer to an earlier question. He and I have worked very, very closely together for 4 years. We are both going to be assisting each other in the performance of our new duties for a period of time.

Senator **Grassley**. Yes. How often will you be meeting with Chairman Volker then?

Mr. **Baker**. I don't have any specific agreement with the Chairman on that, Senator, although I do believe in very close coordination between the Treasury and the Federal Reserve, and I would expect to meet with Chairman Volker on a regular basis and as frequently, quite frankly, as he finds it suitable.

Senator **Grassley**. Do you anticipate regularly scheduled meetings, as Secretary Regan had with Chairman Volker? It is my understanding that they had fairly regular meetings, almost on a weekly basis.

Mr. **Baker**. Yes, they did, and I would anticipate that those would continue, but I haven't as yet discussed that in detail with Paul.

Senator **Grassley**. Yes. One specific item, and you may not be able to respond to this orally, so I would invite you to do it in writing. I have had a chance in your position as White House Chief of Staff to visit with you about the farm problem. In the farm debt restructuring program that the President announced in September, there are some tax consequences of the commercial bank part of that where the commercial bank would agree to a write-down of the debt.

There is some belief that the definition of income will cause adverse tax consequences offsetting the beneficial impact of the President's debt restructuring program. I would hope to examine that situation and work with you so that if the tax implications detract from that overall program, we could work together to change the tax law accordingly.

The CHAIRMAN. Could you wrap it up?

Senator GRASSLEY. I thought maybe I could finish my question.

The CHAIRMAN. You can.

Senator GRASSLEY. OK, but you want me to do it very quickly.

The CHAIRMAN. You have got it.

Senator GRASSLEY. OK. The other matter would be, in cases of farmers, who due to debt restructuring are forced to sell parts of their land, and as a result of a capital appreciation, are subject to the alternative minimum income tax. These are a situations where people who are really forced into bankruptcy and yet have a tax consequences that really prevent their benefiting from debt restructuring.

Mr. BAKER. Senator, I cannot answer that question. I would be delighted if you want to submit it. Then, we would be delighted to get you an answer to it. I will certainly take a look at that. As you and I have discussed, I personally view the farm debt situation as something that I should personally become involved in, assuming I am confirmed. It is a serious problem. It affects a number of the nation's banks, and we did try to do something last September—the administration program—and if it is not doing the job, then perhaps we ought to take a look at other remedies. But in particular, we have got to consider what the consequences of the possible failure of a number of banks in the farm States would be for the general economy.

The CHAIRMAN. The Democrats have gone out, Jim, to caucus on a matter totally unrelated to your nomination, and they will be back in a moment. And I will slip them back in the proper order when they get back. For the moment, we will drop down to Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman, and welcome to the committee, Mr. Baker. I look forward to working with you, once you are confirmed, which I predict will be very shortly. In view of the fact that the cost of labor and capital are the two biggest items with respect to America maintaining a competitive edge in business, don't you think that any tax reform bill should reduce the cost of capital and not increase it?

Mr. BAKER. I think it would be advisable if that can be done, Senator.

Senator SYMMS. Then, that is a goal that we should shoot for?

Mr. BAKER. Yes, sir, if that can be done, consistent with the overall purpose of simplifying and making the system more fair.

Senator **Symms**. The economists and accountants and so forth that I have talked to have said to me that the Treasury proposal will actually increase the cost of capital, instead of reducing it, although there is one part of it which talks about passing through 50 percent of the dividends, which I happen to favor that portion of the bill. But the point I would like to make here is: Is it your position that anything that passes the Congress and in the future with respect to tax reform should be prospective, and not retrospective, and should not start before the date of enactment?

Mr. **Baker**. I spoke to that earlier, Senator. The Secretary of the Treasury has issued a statement. He issued a statement just before Christmas about the transition rules and the grandfather provisions that are already in the bill and made it clear that it is the Treasury Department's intention that there be no undue economic hardship, that we want to reduce the uncertainty. I am not in a position to say today that we ought to say that it has to be totally retroactive. I am in a position to say that——

Senator **Symms**. That it should be prospective, do you mean?

Mr. **Baker**. I mean that there should be no retroactivity. Sorry, yes. I am not in a position to say that today, but if confirmed—once I get over there—one of the first things I will do is take a look at whether or not investment decisions are still being delayed by virtue of uncertainty over the effective date of this program. And it may be that we will have to do a lot more than Treasury has already done.

Senator **Symms**. For example, with respect to the taxation of life insurance companies, this also is very effective in real estate developers. They have stopped making decisions based on the fear of what is going on out here—what may go on down here in Washington. We worked in 1982 and 1984 to straighten out the life insurance program. Then the same Treasury that was in on working it out came up with a recommendation that would tax the buildup on policies and treat it as taxable income, which would virtually put insurance companies out of business as they currently do business. Now, just on something like that, wouldn't we like to say that anything that changes will not affect what they are doing now with respect to the policies they are selling?

Mr. **Baker**. Perhaps so, Senator. Again, I would really like to commit to you, which I will do, that one of the first things I will do over there is take a look at this question of retroactivity and uncertainty respecting investments. As Senator Boren pointed out, it is true also with respect to the energy industry. There are a number of people delaying investment and exploration decisions because of uncertainty.

Senator **Symms**. Right.

Mr. **Baker**. And I think we need to do something about that. I am simply not in a position here today to tell you.

Senator **Symms**. OK, but you will look at that?

Mr. **Baker**. Yes, sir.

Senator **Symms**. I would like to urge you to get the President to speak to this issue also because I think it would help clarify things in the country. Now, how do you propose to prevent the Internal Revenue Service, when you become Secretary, from imposing unnecessary paperwork burdens on the public, such as their recent temporary regulations on company cars and pickup trucks?

Mr. BAKER. I would propose that we do something about those regulations, and I suppose there is no subject with respect to which we are receiving a greater volume of mail.

Senator SYMMS. It is an open secret in town that you are a great baseball fan. Maybe you need to take a baseball bat to them. [Laughter.]

Mr. BAKER. I do think the mixed-use regulations are, frankly, right now somewhat of a mess, Senator. However, there is a substantial amount of revenue there that should not escape taxation, but the businessman and the guy who owns a pickup truck and uses it to take his wife to town to a movie on a Saturday night ought not to be put through a blizzard of paperwork. We ought to find some sort of safe harbor rules or regulations that would take care of the problem.

Senator SYMMS. Thank you very much. I just have one last question. I can see I am about out of time. With respect to the retroactivity and the embracing of the Treasury's tax proposal. Now, you have not—if I heard you here correctly—personally embraced, nor has the President personally embraced, the Treasury proposal.

Mr. BAKER. That is correct.

Senator SYMMS. And I think that is good that you haven't because I do have figures that were just released by Arthur Anderson that a family of four where the father makes $20,000 a year, the mother makes $15,000 a year, they own their own home and have a mortgage interest deduction, under the Kemp-Kasten bill, their taxes would be raised 28 percent. Under the Bradley-Gephardt bill, their taxes would be raised 50 percent. Under the Treasury reform proposal, their taxes would be raised 85 percent. So, I think that we should figure that that is only a starting place.

Mr. BAKER. That is our position, Senator—that it is only a starting point.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Steve. Now, we will go back to Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman. Mr. Baker, Secretary Regan allegedly made the statement that deficits don't have any impact on interest rates.

Mr. BAKER. OK.

Senator PRYOR. Whether he said that or not, right now I don't care, and I think that may be moot. What is your position on that statement?

Mr. BAKER. My position, Senator, is that we need to do something about this deficit, No. 1. Second, we need to do it on the spending side. And third, we need to do it as promptly as we can—something about reducing it.

Senator PRYOR. Do you feel that deficits do or do not have an impact on interest rates?

Mr. BAKER. I think the jury is perhaps out on that, if you take the following things into consideration. Interest rates under the prior administration reached a level of 21 percent—20.5 percent. The deficit was far less than it is today, both in terms of dollars and in percentage of GNP. The deficit has not been decreasing here recently, and yet interest rates have been going down. I think the deficit can have an impact on interest rates, but I think both fiscal and monetary policy combined affect interest rates, and it is not just one or the other.

Senator PRYOR. Your position is that spending cuts can have the most significant impact on reducing the deficit. Is that correct?

Mr. BAKER. I think the way to reduce the deficit is on the spending side, Senator, and not on the revenue side.

Senator PRYOR. In the President's eloquent inaugural speech the day before yesterday, he mentioned the word "freeze." You have mentioned on page 2 of your statement the word "freeze" and you have addressed, I think, and answered several questions relative to a freeze. Am I not correct in saying that the administration's definition of freeze is somewhat different from, let's say, Senator Holling's definition or approach or Senators Grassley's or Kassebaum's approach to a freeze? Are we talking about two different types of freezes?

Mr. BAKER. Yes, sir, we are. You are talking about a freeze of outlays—net outlays.

Senator PRYOR. Program outlays, exclusive of interest. Yes, Mr. Baker. Right. You have stated that the administration's position—the President is holding fast to no freeze on Social Security, no freeze on defense, no freeze on tax indexing, and yet you have stated that you are attempting to achieve a $50 billion savings in expenditures. Now, my question. Where will these $50 billion in expenditures come from, if you would just rough out your plan, if those are exempted?

Mr. BAKER. I really shouldn't lay the President's budget out before he presents it to you on February 4, but let me just say that those reductions will come on the domestic side and partially from defense. There will be $8.7 to $9 billion of reductions from the defense budget. The remaining $40 or $41 billion will come on the domestic side, from a whole host of areas.

Senator PRYOR. What would you say that the percentage increase in defense expenditures will be in fiscal year 1986 over 1985 under your proposal?

Mr. BAKER. In real terms?

Senator PRYOR. In real terms.

Mr. BAKER. I think, Senator, that it is going to be in the 6- to 7-percent range, but I'm not positive that that is the exact percentage.

Senator PRYOR. We are talking about a sizable increase in defense?

Mr. BAKER. Yes, sir.

Senator PRYOR. Actual dollar outlays, and freezing—and exempting, I should say—from the freeze others. Won't there be disproportionate cuts, therefore, in some of the domestic programs if these are exempted?

Mr. BAKER. It depends on, I suppose, your outlook. Some would argue that we have, from the period in the late—that we have neglected up until recent years—seriously neglected—defense, and they would argue that the place to get it is over on the domestic side.

But others would argue that for the last 4 years we have been doing that—we have been doing it to the domestic side—and we ought to do it on the other side.

Senator **Pryor**. My time is up. Thank you, sir.

The **Chairman**. Thank you very much. Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman. I wish to join the others in congratulating you, Mr. Baker, on your nomination. And regardless of what is said and asked here, it appears that you are on a greased track to confirmation. [Laughter.]

However, I would like to find out whether you fully support all aspects of the Donald Regan proposal.

Mr. **Baker**. The tax reform proposal?

Senator **Matsunaga**. Yes.

Mr. **Baker**. No, Senator. I have, I hope made it clear that this proposal is nothing but a starting point. It is what the Treasury Department came up with in answer to the President's request to go examine various ways that we can make the tax system fairer and more simple and encourage—stimulate confidence on the part of the American people, not only in our tax system but in our Government.

And this is what has resulted. We see it simply as a starting point.

Senator **Matsunaga**. Fine. I am glad to hear that. I am glad also to note in your opening statement that you believe—as a matter of fact, you say—we must increase incentives for savings and investment, because under the Regan proposal, the tax incentives for development of alternative energy are eliminated.

I might point out that cuts in Government spending are limited because of the large proportion of government entitlement, programs in the budget. And if we agree that there is not going to be any tax increase—that is in the rate of taxation—the only other way we can go is to increase the tax base. Do you agree?

Mr. **Baker**. Yes, sir—with your last statement.

Senator **Matsunaga**. Increasing the tax base can be done from past experience by providing tax incentives. And little is known of the fact—and you can check into this—that in the area of energy—alternative renewable energy development—we have found, and the independent studies have so shown, that for every $1 of tax credit given since the tax credit was initiated, the Federal Treasury has enjoyed additional revenues of $9. This is a great investment.

And I might point out the experience in Hawaii, when I was still a member of the Hawaii House of Representatives—and served as majority leader. I was approached by businessmen to provide a tax moratorium of 8 years, in order to enable them to start a new industry—the macadamia nut industry. [Laughter.]

There was no macadamia nut industry at that time, so we went along with the businessmen and gave them a tax moratorium for 8 years. That is the period required for the trees to bear fruit. Today the industry is up to $55 million and is projected to reach $240 million by 1990. This new industry today brings in taxes to the State of $2.68 million—never before known—and by 1990 will bring in $14 million. This is an all together new industry.

That is only at the small State level—the small State of Hawaii. Just imagine what can happen nationwide. So, I do hope you will stick by your opening statement. And as you know, the energy tax credit expires the end of this year, and I hope that you will strongly encourage not only administration members but Members of Congress to extend that tax credit.

Mr. BAKER. Senator, could I say that there are aspects of this plan, and I think perhaps we are losing sight of these facts, that do encourage savings and investment. There are rate reductions for the American people in this plan, and we have seen what personal rate reductions can do toward stimulating economic growth as a result, I think, of the 1981 rate reductions.

There are rate reductions for corporations in this plan. There is a provision whereby a corporation gets a credit for dividends paid—a credit—50 percent of the dividends paid. So, there are extensive provisions, I think, in the current plan for savings and investment.

Senator MATSUNAGA. I see that my time is up. Mr. Chairman, I have other questions later.

The CHAIRMAN. We will have another round of questions.

Senator MATSUNAGA. All right.

The CHAIRMAN. Senator Roth.

Senator ROTH. Mr. Baker, I, too, want to congratulate you for being willing to undertake this onerous job. I was very much pleased to hear your last comment about rate reductions—how important that was to the economic recovery.

I would like to point out that there are a number of people that are concerned that the tax reform program is really a stalking horse for tax increases, that, in fact, it will collapse because it is taking on too many interests.

So, what ultimately will happen is that we will have a revenue enhancement eliminating some of the so-called tax shelters, deductions, and credits. Do you think this a possible scenario of the future?

Mr. BAKER. I would certainly hope not, Senator, and we are going to do everything we can to avoid that being the result.

Senator ROTH. I would also like to point out that many people are concerned that the emphasis is on deficit reduction. There are many ways to reduce the deficit.

And there is a long editorial—I don't know whether you have seen it this morning or not—in the Wall Street Journal, but it says that deficit reduction is really a code word for tax increase. When the chips are down again, that the ultimate purpose will be to include as part of the overall package a revenue increase. I would like your comment on that as well as another statement pointed out there that what we should really be concerned about is growth. And by growth, we have to reduce Government. We don't reduce Government by increasing taxes, but by reducing spending.

The editorial goes on and points out that a freeze, while important, doesn't have any long-term impact on reforming those programs that are expanding. Would you care to comment on that?

Mr. BAKER. I agree with the statements with respect to growth, Senator. With respect to whether or not deficit reduction is a code word for tax increases, it certainly isn't in the way we use it in the

White House or at the Treasury Department. We are not talking about tax increases.

There is no sentiment within this administration that I am aware of for a tax increase. We think that if there is one issue that was at the forefront of the last national election we had, it was the issue of raising taxes. And we think that the American people spoke very loudly with respect to that issue, and we think that their view is that, yes, we should do something about the deficit but we should do it on the spending side.

Senator ROTH. I agree very much with that statement. I would just point out there is a lot of talk in the back rooms that ultimately we are going to have to have a tax increase. So, I think the Treasury and the administration ought to be on guard.

Mr. BAKER. You haven't seen any such talk coming from the administration, Senator, nor will you. I would grant you that once raising taxes becomes an alternative, it makes it just that much tougher to do what is required on the spending side.

I suppose it is always easier for those of us in the executive branch and those of you in the legislative branch to go that route than it is to cut spending.

Senator ROTH. Mr. Baker, I have just returned from Japan. I haven't been there for 3½ years, but it is indeed impressive how their economy is continuing to grow and expand. The thing that interested me—and I had the good fortune to talk with people like Mr. Nakisone, the Prime Minister, as well as industrial leaders—and the one word they all have is, that much of their success has been dependent upon savings—savings by the individual Japanese, which is something like 20 to 24 percent, in contrast to our rather miserable performance of 4 or 5 or 7 percent.

One of my concerns about the Treasury proposal—and I understand it is a starting point—is that it does very little in the way of developing incentives for savings. It seems to me that for our long-term growth, to ensure necessary capital investment, that we have got to do better.

And I wonder if you would care to comment on that aspect of the Treasury proposal and whether you would be willing to consider an expansion of savings incentives?

Mr. BAKER. We would be willing to consider that along with anything else, Senator, because this is indeed a starting point. As I pointed out earlier, I think there are savings and investment incentives in the proposal that Treasury has come up with. But yes, sir, we would consider that.

Senator ROTH. My time is up, but just let me say in closing that I don't personally think they go nearly far enough. And frankly, I don't think we are going to get any real tax reform through unless the working people—the middle class—see themselves benefiting from the tax reform.

The problem with the Treasury proposal—and frankly, the problem with all the other proposals—is that middle class is not going to be certain that they are going to really get a tax break. They see it as a possibility of a tax increase, and I think that must be studied.

The CHAIRMAN. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman. Jim, let me add my words of admiration and affection for you in wishing you well as you go forward. I am particularly glad that you are still Chief of Staff of the White House and not coming to us in green from Wall Street or some other part because I would assume then that you had written, and not somebody in Treasury, the opening statement which you gave, which I really would have to define as sort of tapioca, which is an undefinable thick fluid surrounding equally sweet squishy lumps, and when you have finished it, you have found it totally unsatisfying. [Laughter.]

This is just full of platitudes and devoid of definition. You know, like bring greater fairness to the American tax system, cutting wasteful and unjustifiable Government spending, and pursue monetary policies that keep inflation down, and help strengthen the international monetary system.

You know, I would assume that if you weren't as busy as you are, you would have prepared that statement along the lines of your response to these questions, and you know, they are a whole lot better.

But what troubles me is much of what Senator Roth was just referring to. It does keep coming back up with sufficient frequency to cause genuine concern and that tax increase is behind all of this tax reform talk. We talked yesterday, and assuming that you can get a whole sort of restructuring of the Tax Code along the lines of any of the three proposals which have some similarities, the transition rule alone, it seems to me in a time of high budget deficit, is going to be the one thing that brings it down because you have a choice of either a tax increase to cover it, an increase in the deficit, or simply walk away from legitimate commitments that the country made to people who were investing in the strength of the economy that was reported this morning. Do you want to make any comment on that?

Mr. BAKER. I am not sure I understand, Senator.

Senator WALLOP. Somehow or another, all of these Americans who have made commitments on the Tax Code, as they understand it, and I don't know who understands it now with three tax bills in 4 years, and now we are looking at a fourth in 5 years, and we haven't got any rules out of the one we have just passed, but people have made economic commitments. Dry cleaners have bought delivery trucks, all the way up to great power companies have made commitments to buy generating turbines from major manufacturers, all based on a tax cut.

Now, it seems to me that when you get to the transition between where the Tax Code is today and where it might be if we have brought it greater fairness and simplicity, which I think are code words that really signify nothing—nobody has defined what they are—but assuming that they are like any of the three proposals in their similarity, you have only three choices.

One is to raise the taxes to cover what is going to be a deficit by virtue of allowing grandfather situations to continue, or two, is to increase the deficit by ignoring them and letting the transition take it, or three, is to simply walk away from the commitment of the Government that it made in the Tax Code as it was.

Mr. **Baker**. I don't think we would admit, Senator, that the job can't be done on a revenue-neutral basis. I think it can be done on a revenue-neutral basis, and I think it can be done without undue hardship. And it is extremely important that we see to it that the transition rules are sufficiently liberal, that the grandfathering provisions are sufficiently liberal, that the guy that bought the fleet of trucks as you used in your example is not hurt.

Senator **Wallop**. OK. I agree with that to be the purpose, but then you have two ways to get that done, and I am so close to running out of time. One is to allow the deficit to increase to cover it or to tax somebody else to cover it, if you are going to have the transition.

And that is why I think that at this moment in time it is a more complex thing that people believe.

Mr. **Baker**. It is very complex, and it is a very ambitious undertaking, and we do not seek in any way to minimize the scope of the job, Senator. We don't. The goal is a very, very worthy goal, and the President feels it very, very strongly, that if we can get there, it is something worthwhile giving a try.

Senator **Wallop**. One last thing. That has to do with the rules that you mentioned with Senator Symms that are causing Treasury a lot of mail and causing me a lot of mail and causing a difficulty in getting off of airplanes in Wyoming with having people come up and say: Is there any way that you would consider creating some kind of a little council of small businessmen and big businessmen to just review a few of the things that happen in the way of rules promulgation to avoid that kind of embarrassment to our country?

You have said there is maybe a significant revenue to be picked up there, but what has happened is: There is 5 percent of the people who are maybe owing that significant revenue and 95 percent are the good, honest small businessmen and big businessmen in the country who are driven nuts, and they don't believe in us when we do things like that.

Mr. **Baker**. And that is a result we want to avoid, Senator, and we will do anything in the world to avoid that.

Senator **Wallop**. Try a little council of people who actually live in the world. Thank you.

Mr. **Baker**. I saw a lot of it in 22 years out there.

The **Chairman**. Thank you very much. We will go through on a second round, and Senator Moynihan is first.

Senator **Moynihan**. Thank you, Mr. Chairman. I want to raise the general subject of the Treasury Department's responsibility in narcotics. May I first say, Mr. Secretary—as you soon will be—I hope we don't get ourselves into a situation where we all agree that we are going to do something about the deficit, while we simultaneously agree that we will not do any of the things that could affect the deficit.

It is a pattern in Government. We can talk about spending as much as you like, but the single item in the budget that is growing faster than any other is the interest in the debt. That has almost doubled in 4 years, and we know that.

Not to be difficult, but you said we have to cut spending, and in your testimony you say: "At the start, we must work together to enact a freeze on total Federal program outlays for fiscal year 1986 relative to 1985." Does that refer to Defense? Are we going to freeze Defense?

Mr. **Baker**. No, sir. We are talking about aggregate spending. If we spent $836 billion in fiscal year 1985, we would spend no more than $836 billion in fiscal year 1986.

Senator **Moynihan**. That is all I mean, Mr. Secretary. Whenever you get down to specifics, we find, you know, we won't do this and we won't do that. I am just saying that if this pattern does not change, neither will the deficit.

Can I ask you about another aspect of your job, and one that is extraordinarily important to the country: The drug interdiction program. You are responsible for the Customs Service and Customs is responsible for keeping drugs out of this country. And it has done so with results that are, at best, questionable.

And I don't know if it can do it very well. Two questions, and maybe the chairman should hear this, because he might be interested.

If you had the Coast Guard working with Customs, do you think you could do a better job? Much narcotics comes into this country by water. If Coast Guard and Customs could get together, the interdiction effort could be more successful. Do you think that this is an aspect of your job that you are going to find some time for?

Mr. **Baker**. Yes, sir.

Senator **Moynihan**. And can you think of some ways that we can help you?

Mr. **Baker**. Yes, sir. I do think of it as a major aspect of this job, and I will find time at the secretarial or deputy secretarial level. It has been my understanding that the Deputy Secretary--the current Deputy Secretary—has spent a good bit of time on it.

Senator **Moynihan**. And Mr. Darman will do the same?

Mr. **Baker**. I don't know, but we will work that out. It is something that interests me, and maybe I will find time to do it, but it is extremely important in my view. Insofar as your question about the Coast Guard is concerned, there has been rather close coordination recently between Customs and the Coast Guard as a result of the Vice President's task force on drug interdiction, and in fact, Customs, the Coast Guard, and DOD have worked rather closely together.

We have had an increase, Senator, as you know, in the air assets of the Customs Bureau, in the budget therefor—a rather significant one. We have not been able to do as much as we would like to do by way of interdiction, and there are still way too many drugs coming into this country.

I think way too many, and we realize that this is a tremendously big job, and it may be that we are not devoting enough assets Government-wide to it. I don't know. The coordinating mechanism that the Vice President has chaired has worked, I think, very well, based on what I have been told. I have not attended those meetings.

I do think we have to give some consideration to the demand side of this problem. I think the First Lady's activities, for instance, have been very helpful in that regard. And I don't know whether we could ever stop, by way of interdiction, everything that is coming in. I think we have got to do more, if we can, but I also think we have to do more on the demand side and see what we can do about educating the public.

Senator **Moynihan**. This may involve some large technological changes in medical treatment. Would you just remember, sir, that you are responsible?

Mr. **Baker**. Yes, sir.

Senator **Moynihan**. It goes with the territory. You are in charge of Customs, and Customs is in charge of or is responsible for keeping narcotics out of this country. It can't now do it. Mr. Mullins has said that the Narcotics Boarder Interdiction System that was set up in 1983 hasn't worked. Now, this is just the most recent thing that hasn't worked, and it is very good of you to say what you did, and I am taking you at your word for it. Thank you.

The Chairman. Senator Boren.

Senator **Boren**. Mr. Chairman, I would say I was enthusiastic about this nomination when I came in today, and I am even more so now after hearing what I think are very balanced and thoughtful answers to the questions that have been asked today.

Mr. Baker, I would like to raise one point. We talk in terms of fairness and soundness in a tax system. Do you feel as a matter of general principle that, when we look at rates of taxation, that it is fair or appropriate that we also consider elements of risk? I am somewhat concerned with the idea that seems to be creeping in that we should apply exactly the same rate of taxation to every enterprise without regard to the risk that might be involved in that enterprise and that we might then drive capital out of all—whether it be startup of new high-tech companies or whatever the field might be—that we might drive capital out of areas that give vitality to our economy. If we don't at least, although not always, give some consideration to rates of risk.

Mr. **Baker**. I think consideration has been given to that in the past, Senator, and probably properly so. On the other hand, I think we also need to keep our eye on the ball if we are going to have a system that the American people think is fair. We have got to make sure that any preferences we give are indeed fair.

Senator **Boren**. So, they have to be genuinely justifiable?

Mr. **Baker**. Yes, sir.

Senator **Boren**. Well, I certainly agree with that, but you do think that the amount of risk involved in an enterprise, at least, is an appropriate factor to be weighed in considering tax burdens?

Mr. **Baker**. I think so.

Senator **Boren**. In the area of encouraging investments, I would just urge that we do want to get our rate of investment up, that we also consider the competitive cost of capital from one country to another. Some recent studies have indicated that, for example, the marginal net cost of raising new capital in Japan—and it is due to a combination of factors—interest rates, tax laws, and the rest—are much lower than the cost of new capital formation in this country.

And of course, that leads to naturally lower rates of investment and makes us less competitive. I wonder if the Treasury itself has undertaken any studies at this point of the net cost—the competitive cost—of capital in the United States compared, say, with the cost of capital in other nations with which we must compete in international trade?

Mr. **Baker**. I am not aware of any, Senator, but we will certainly find out.

Senator **Boren**. Is that an area that you might be willing to pursue in terms of taking a look at it, and if there is a disadvantage in this country, trying to uncover the cause?

Mr. **Baker**. Certainly. I think such a study could prove useful. They may have one over there. I am not aware of that.

Senator **Boren**. And I wonder, finally. There has been a lot of talk about capital formation, and that is something we have worked for a long time—and long before I came on this committee—they were working on trying to reach a concensus that we needed to increase capital formation and saving in the country so that we could retool, modernize, have new research and development, expand our economy.

When the capital gains taxes were cut, I have seen various figures that indicate that in the venture capital markets there was an increase anywhere from fourfold to eightfold in the next 6 or 8 years following that cut.

I wonder if a study has been made yet by Treasury of the total impact. I realize there are individual items of incentives on savings and investment of the Treasury tax proposal, but how much of the total impact—what is the net total impact of this change in terms of, let us say, encouraging consumption by cutting individual income tax rates versus discouraging investment by increasing the tax burden on the business side?

Has there been any kind of study that would give us a net evaluation of the total impact of this proposal on capital formation versus consumption?

Mr. **Baker**. I am not aware of one, Senator.

Senator **Boren**. I would hope that we would examine that. I would like to see tax simplification. I would like to see us hold down individual rates as much as we can. There are other ways of doing it. Consumption approaches. Those approaches would put more burden on consumption, as opposed to investment.

There may be other ways to get to the goal of simplifying the tax system and reducing individual income taxes, and I just hope that we take a very sharp look at that comparative burden. Thank you, Mr. Chairman.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman. Mr. Baker, you have heard from a number of the members today about their own special concerns. And I suppose that when you face the question of tax reform, that is ultimately going to be the decision that the President has to make.

Is he going to be willing to take on all the special interests in order to give the American people the lowest possible tax rate? That is the question. Not to you—that is for the President, and for you to think about.

Let's take one example—the issue of capital formation, which has historically been thought of in terms of giving one tax rate for one kind of savings vehicle and another tax rate for another savings vehicle and another tax rate for another investment vehicle and yet another tax rate for another investment vehicle—all of which are taxed at a lower rate than what the American working person has to pay in tax.

So, I wonder if you wouldn't agree with a lot of economists in this country that the best stimulus for economic growth in this country is a low rate, neutral broad, based tax system?

Mr. **Baker**. I would be inclined to agree with that, Senator. I am not an economist, but I think that as a formula for growth, we have had the experience over the last 2 or 3 years with what reducing rates can do. And it has been pretty impressive.

And if you look at the numbers this morning, I think you have to be impressed.

Senator **Bradley**. And if you join the initiative that the President took under your leadership and with Don Regan's leadership in 1981 to get rate reduction with the actions taken in 1982 and 1984—largely emanating from this committee—to make the system fairer by closing loopholes, if you join those two together you would get the benefit of both—low rates for stimulating work, savings, and investment, and greater fairness for the American taxpayer.

Mr. **Baker**. That is correct.

Senator **Bradley**. Now, Senator Symms went into this long discussion about reducing the cost of capital. I thought that the Treasury looked at a consumption-based tax.

Mr. **Baker**. They did.

Senator **Bradley**. And they rejected a consumption-based tax for a low rate income tax.

Mr. **Baker**. They did, for a modified flat tax.

Senator **Bradley**. Isn't it your view that you are committed to a low rate broad-based income tax, not to a consumption tax?

Mr. **Baker**. That is correct, Senator. And when I say that the Treasury proposal is a starting point, I don't mean to be suggesting that we are considering other forms of taxes.

Senator **Bradley**. Absolutely. And then, Senator Wallop's concern that here are all these companies that have made these big investments, and suddenly they are going to have to adapt to a world where it is the American people who are going to get a low rate, not just particular corporations.

But my point is, isn't his concern about tax increases from restructuring the code somewhat unfounded, because many corporations have already written their investments off because the combination of ACRS and the ITC is more generous than expensing. So switching to a neutral depreciation won't hurt a lot of the investments that have already been made.

Mr. **Baker**. I don't think I would characterize it as unfounded, if I understand it correctly. Both his and Senator Boren's concerns are that investment decisions are being delayed because of uncertainty with respect to whether or not we will in fact move in this direction. Not so much, I don't think, about past decisions—they weren't speaking so much about past decisions.

And quite frankly, I do think we need to take a look at the transition rules and the grandfather provisions and make sure that in moving in this direction we don't stifle for a 6-month period of time investment and that sort of thing.

Senator **Bradley**. If I read the Treasury report clearly enough, it said that any effective date would be the date that a bill is submitted to the Congress. That is what the Treasury report said. So, if you want all these goodies, if you are afraid you are going to lose them, it seems to me that ought to be a big stimulus to go out and invest now because you are going to be grandfathering. You are going to take in all those goodies. Is that not correct?

Mr. **Baker**. Some have argued that. That is why I say it is really something we need to take a look at after we get over there.

Senator **Bradley**. Thank you.

The **Chairman**. Let me pursue with you, Jim, a subject you and I have talked about before so that it is very clear on the record: The difference between simplification and fairness.

And I will use as an example the presently untaxed health insurance benefits.

Mr. **Baker**. I am sorry, Bob, I didn't hear that.

The **Chairman**. The difference between simplification and fairness, because I often find that people are talking about one thing, and they mean another.

Mr. **Baker**. Yes.

The **Chairman**. The example that I have often used in this committee is the statement of Mr. Block of H&R Block, who testified some years ago. And I talked with him within the last week, and he still corroborates the statement.

He says that when average citizens in this country, two-thirds of whom file a simple return—they file a 1040EZ or a 1040A or a 1040 with six or fewer deductions—it is a simple return—when they are asked the question of simplification, they think fairness.

But when he actually broke it out and asked them a question: Are you concerned about your tax as being complicated? The answer is no.

So, for two-thirds of the people, simplification for the sake of simplification is not an issue. In terms of health insurance benefits, at the moment the premiums paid by the employers are untaxed.

So, you are employer Smith and you contract with Aetna or Blue Cross or Blue Shield or Continental Casualty to provide health insurance for your employees, and it costs you $250 a month per employee, and you send a check per employee to them, and they pay the bills. That is relatively simple.

If we are going to tax that and it becomes income, the employer is going to have to withhold because it is income. The employee is going to have to count it as income. It indeed is going to make the code more complex for the employer and the employee, and no one should try to sell that idea on the basis of simplification. I will argue with the merits and the fairness, but I find that people confuse the issues.

And I don't want us to get conned into some form of tax change, promising simplification, and when it is all done, many people find out that it is unfair.

Mr. **Baker**. I understand that, Mr. Chairman. If you look at my statement, I have moved the word "fairness" and put that first and "simplification" second, as a result of our conversation, because I quite agree with that.

The **Chairman**. Yes.

Senator MOYNIHAN. Mr. Chairman, I had finished but you raised a point that presses on me. Under the Treasury proposal, will individuals have to pay taxes on the interests that accumulate on their life insurance policies each year?

Mr. BAKER. Senator, I don't know.

Senator MOYNIHAN. I believe so. It is called the inside buildup, but most people don't know that. They buy life insurance and wait until they grow old. But every year you have to find a line on your tax return to calculate the interest on the policy?

The CHAIRMAN. The answer is yes to their program. The question is that simplification? Clearly no. It is more complex. Is it fair? Again, I don't think so, but that is a matter for debate and discussion. I just don't want us to get fooled into acting on the basis that simplification is the way to go. I mean there are two ways you can go. I mean, a sales tax is simple, relatively easy.

A flat tax with no deductions is simple, and we could raise about the same amount of money in this country that we raise out of the personal income tax with a 14 percent flat tax—no deductions—not for children, not for medical, not for anything.

What it means, as a rule of thumb, is that everyone who makes $30,000 or more will pay less taxes, and everyone who makes $30,000 or less will pay more taxes, as a rule of thumb. Is that fair? I don't think so. Is it simple? Very simple.

But we are not necessarily going to get both in the same bill. Senator Matsunaga?

Senator MATSUNAGA. Thank you, Mr. Chairman. Following up on the employee benefits which employers now provide in the area especially of pension and health, there is a division of views even on this committee on the proper tax treatment of such benefits. What is your view about providing incentives for employee benefits provided by employers?

Mr. BAKER. I think the question of the taxation of fringe benefits or employee benefits is again something we are going to have to look at. I am well aware of the chairman's view in this regard. I will say this, Senator: If you are going to lower everybody's tax rate, and if you are going to bring fairness to the system, you have got to take a close look not only at the special deductions that people get, but you have also got to take a look at income that is not taxed.

And that is the reason that you see the treatment that you see of those things in the Treasury plan.

Senator MATSUNAGA. Yes, of course. What I am talking about are benefits which are now being provided under certain incentives. It appears now that simplification of our tax system is not going to be simple.

And in the light of that, did I understand you to say that you hope to have a package before the Congress by August of this year?

Mr. BAKER. No, sir. You have heard me on several occasions decline to express a timeframe or a date because I really can't do that. I don't know. I will agree with you that it is not going to be simple.

Senator MATSUNAGA. Right.

Mr. Baker, we ought to consider very seriously the complaint lodged by so many of my friends, especially in small business. They complain, "Sparky—the trouble with you guys is that you change the tax laws so damned often we don't know how to plan ahead." And it seems that if we are going to rush into something this year, and next year we find that we made a mistake and we change it again we are simply adding to the instability in the business world.

The businessmen refuse to expand the business or refuse to go into new businesses, not knowing what to expect and what taxes they will be required to pay. So, the less we change the tax system, the better it is, the better incentives we provide to businesses to expand and to go into new businesses, the better our economy will be.

So, perhaps we ought to make a thorough study of this this year and early next year, and perhaps set a target date for the second session of this Congress before we come up with a bipartisan tax simplification program or fairness program. What do you think?

Mr. BAKER. Senator, I would respectfully have to disagree with that. The President thinks that this is sufficiently high priority with him that he wants to try and do it this year, recognizing all the while that it is a very big undertaking.

I suppose there is a certain amount of certainty that the businessman would get if he knew that there were going to be simply—in this Congress—there was not going to be any tax legislation.

If this is indeed a worthy goal in and of itself, if indeed our tax system does have some fairness problems with it, if the people believe—as I think they believe—that there are fairness problems in our tax system, and if confidence in the tax system and confidence in Government is being affected, I think it is a worthwhile undertaking this year.

Senator MATSUNAGA. I make the suggestion simply in the light of the tax neutrality of the proposal. And there is no tax neutrality really if some are going to pay more and some are going to pay less under the plan.

And I think the confidence of the American people can be gained by showing that we are searching for something fair, not merely simple. No further questions, Mr. Chairman.

The Chairman. Thank you. Do you have anything further?

Senator BRADLEY. Just one or two. Mr. Baker, you indicated that—a number of members expressed concern for various provisions, as I said earlier. Under the Treasury proposal—while I realize you haven't embraced it, or the President hasn't—how many people end up paying less tax? The same or less tax?

Mr. BAKER. Senator, I think it is 78 percent.

Senator BRADLEY. So, 78 percent of the people, even after considering all of the other provisions that are now taxable, end up paying the same or less tax?

Mr. BAKER. That is correct.

Senator BRADLEY. And 20 to 22 percent of the people end up paying more tax?

Mr. BAKER. That is correct, sir.

Senator BRADLEY. Now, would you agree further that the people who end up paying less broadly defined would be the people who are now paying tax?

Mr. BAKER. Broadly defined, yes, sir. I think there are a number of the people in the 22 percent who are paying tax, too.

Senator **Bradley**. Yes, well, they are paying a little more.

Mr. **Baker**. That is right, but they are paying tax now, I mean.

Senator **Bradley**. And I think that is an important thing for us to continue to focus on because, in addition to that fact, where 78 percent pay the same or less and 22 percent pay more, that is simply a reading of the proposal run through the latest year of tax returns.

Mr. **Baker**. That is correct.

Senator **Bradley**. But prospectively, what those 78 percent and indeed the other 22 percent is a lower tax rate. And doesn't it stand to reason if they earn more money with a lower tax rate, they will keep more as the years pass?

Mr. **Baker**. And invest more.

Senator **Bradley**. And keep more.

Mr. **Baker**. And keep more.

Senator **Bradley**. All right. Let me ask just one other question. On the trade question, you referred to—you said what many people from every administration have said in just the six years that I have been here have said: Above all, we don't want to return to protectionism.

Do you support what the administration did on specialty steel on quotas?

Mr. **Baker**. Yes, sir.

Senator **Bradley**. Do you support the administration's attempt to reduce steel imports of basic steel? Already done.

Mr. **Baker**. Yes, sir. You mean last October-November?

Senator **Bradley**. Yes. Do you support the duty on motorcycles?

Mr. **Baker**. Yes, sir.

Senator **Bradley**. Do you support tougher rules on textiles that the administration proposed?

Mr. **Baker**. Absolutely.

Senator **Bradley**. Do you support the quotas on autos that the administration proposed?

Mr. **Baker**. I don't know that we proposed the quotas on autos. Did we propose quotas on autos?

Senator **Bradley**. Yes.

Mr. **Baker**. I thought that those were voluntary restraints the Japanese made.

Senator **Bradley**. My point is only that you don't want to return to protectionism, but that is a pretty good package there.

Mr. **Baker**. But, Senator, every one of those was either countervailing or dumping or surging situations, where we were responding to unfair trade. And what I am talking about when I mention protectionism—not returning to protectionism—is where we simply slap a tariff on because we are not able to compete.

Senator **Bradley**. But my point is, if you think tax reform has a level of rhetoric and a level of reality, the call for open trade also has a level of rhetoric and a level of reality. And I hope that you will look carefully at any of these measures as to what it might mean for the long term. And I think that we would all be better off.

The **Chairman**. Any further questions?

[No response.]

[The following questions from Senators Heinz, Mitchell, and Murkowski were received and answered by Mr. Baker:]

Written Questions of Senator Heinz

Hearing on the Nomination of James Baker to be Secretary of the Treasury

1. The IMF quota increase, which narrowly passed the Congress in 1983, seems to have stabilized the international debt crisis, at least for now.

Could you contemplate any situation which would necessitate going back to Congress for an additional quota increase during your tenure?

Since a quota increase would be so difficult to accomplish, what other strategies could be pursued to deal with a future flare-up of the debt crisis?

Answer:

The 47 percent increase in IMF quotas negotiated in 1983, amounting to roughly $30 billion (to a total of $90 billion), was designed to assure that the IMF had adequate resources to meet normal official balance of payments financing needs through 1988, when the next regular review of IMF resources is scheduled to be completed. Moreover, the agreed tripling of the General Arrangements to Borrow, an increase of $12.5 billion (to $18.5 billion), provided the IMF with an increased capability to deal with emergency situations that threaten the stability of the international monetary system. We believe that this increase in resources provides the IMF with adequate funds to deal with normal requirements as well as possible emergencies and do not anticipate the need to seek additional resources prior to the scheduled completion of the next regular quota review.

The debt strategy, of which the IMF resource increase is a part, has been in place for over two years and is working. It provides a flexible framework for dealing on a case-by-case basis with potential problems that might arise. We are, of course, monitoring the situation closely and will continue to work with other major countries to deal with any emergencies that might develop. However, it would be premature at this time to indicate what, if any, specific steps might be needed to deal with unforeseen developments.

2. The Treasury Department has responsibility for conducting our negotiations in the OECD on export credits. Through good negotiating, backed up by a sizeable Eximbank Loan Program, the United States has been successful in greatly reducing the subsidy element in official export loans and getting the member countries to agree to tie official credit rates closely to market terms. It is widely understood that the Administration is planning to elimminate the Bank's direct loan program in fiscal year 1986. The next round of export credit talks are set for this April. How can we expect our negotiators to have any kind of success at those talks when Eximbank is projected by the new budget to be out of the direct loan business altogether?

Would you suggest a similar approach for our arms negotiating team in Geneva?

Answer:

The need for direct export credit subsidies has dwindled as a result of the Reagan Administration's success in negotiating international arrangements which have significantly reduced export credits subsidies. In 1983, Treasury negotiated improvements in the OECD Arrangement on Export Credits which effectively eliminated direct interest rate subsidies in official trade credits to industrialized countries, and significantly reduced the trade credit subsidies to developing countries. Treasury has also negotiated (1) an arrangement with other OECD countries to limit export credit subsidies for nuclear power plant and equipment, and (2) an understanding with producers of large commercial jet aircraft to limit trade credit subsidies for such aircraft. The demand for Eximbank direct credits fell to less than $800 million in FY 1983 and rose to $1.8 billion in FY 1984.

The Administration will propose the elimination of Eximbank's direct credit program for FY 1986 and a greater reliance on the Bank's guarantee and insurance programs. However, the Administration's budget proposal of February 4, 1985 will still allow the Bank to offer competitive financing. The budget will outline the means to accomplish this objective.

The most significant issue which remains to be negotiated internationally is the elimination of tied aid credits (aid monies) as an export promotion device. We have begun to make some progress on this issue, particularly with the commitment of OECD Ministers to improve discipline and transparency over such credits. Eximbank will continue to offer selective tied aid credits to support our negotiating objectives.

3. As you are aware, the dollar is at an historical high in relation to the currency of our major trading partners. This is a tribute to the success of the American economy during the President's first term, but it can also do great damage to our Nation's export sector--even our most productive and competitive high tech industries, not to mention steel and automobiles. Last week the financial ministers of the so-called G-5, or big 5 industrial nations, met in Washington. At the conclusion of that meeting, Secretary Regan said that the G-5 agreed that they would intervene in a coordinated way "when it would be helpful."

In the past the U.S. has intervened only as a last resort to calm "disorderly markets." Does the Secretary's statement indicate a new more aggressive policy to keep the currency speculators from disrupting the U.S. economy (and that of our allies) by intervening in concert and more often? Would you consider doing so even if this latest statement indicates no basic break with the past?

Answer:

The United States has in fact joined other major countries in coordinated intervention on a number of occasions since the 1983 Williamsburg Summit, and the reference to this subject in the recent G-5 announcement--which specifically reaffirmed the Williamsburg commitment--was not meant to indicate a radical change in policy. It was, however, a reminder that such operations can take place, and that exchange market participants should take this fact into account. I support this position.

At the same time, it should not be overlooked that the G-5 announcement placed major emphasis on the importance--in achieving greater exchange market stability--of pursuing monetary and fiscal policies that promote a convergence of economic performance at non-inflationary, steady growth. Moreover, and most significantly in this connection, they stressed the importance of removing structural rigidities in their economies and expresed their intent to intensify efforts in this area.

Written Questions of Senator Mitchell

Hearing on the Nomination of James Baker to be Secretary of the Treasury

1. On several occasions your predecessor, Secretary Regan, publicly criticized the Federal Reserve Board's monetary policy and generally advocated a more rapid growth in the money supply. Have you agreed with that criticism in the past?

Answer:

I support the monetary growth targets established by the Federal Reserve Board as long as they prove to be consistent with our desire for solid real economic growth at noninflationary rates. Secretary Regan was critical of monetary policy when he felt it was inconsistent with our goal for noninflationary economic growth. He and I have been in complete agreement on the objective of noninflationary economic growth. And we have generally been in agreement, also, with respect to the relationship to this objective of Fed policy and practice.

2. It has been reported that the Treasury Department is studying proposals to reduce the independence of the Federal Reserve Board. Do you support any change in current law to reduce the independence of the Federal Reserve Board and correspondingly increase the power of the Treasury Department with respect to setting targets for growth in the money supply?

Answer:

My primary concern about monetary policy is that it provide consistent support for solid real economic growth at noninflationary rates. While I am aware of low-level studies underway at the Department, I have not seen these studies and cannot comment on them. However, I would support the proposal to make the term of the Federal Reserve Chairman co-terminous with the term of the President, a proposal endorsed by Paul Volcker.

3. During the first Presidential Campaign debate last fall, President Reagan stated his opinion that there is not any connection between federal budget deficits and high interest rates. Do you agree that there is no connection?

Answer:

Economic studies have not been able to confirm a systematic relationship between deficits and interest rates. However, I am concerned about the budget deficits and believe they can have an impact on interest rates. Both fiscal and monetary policy have an impact on interest rates, not just one or the other. The continued growth in our national debt resulting from excessive federal spending raises serious concerns about future economic instability. It is clear that the federal government cannot continue to preempt more and more of this nation's private wealth without doing considerable damage to the economy.

4. If the President endorses fundamental tax reform, will he withdraw his request that Congress approve new tax preference programs for enterprise zones, tuition tax credits, and spousal IRA's?

Answer:

No, the President believes strongly in enterprise zones, tuition tax credits, and spousal IRA's. Therefore, he will not withdraw his request that these programs be approved. Of course, the fundamental tax reform package also includes a proposal for increasing the spousal IRA to the same level as the IRA for employees.

5. What changes would you like to see made in the Treasury tax reform proposal?

Answer:

It would be premature for me to speculate about the changes I will propose in the Treasury tax reform package. The Treasury Department is still in the process of receiving and evaluating submissions by taxpayers and others who feel that various proposals might cause damage. I will not be making proposals for changes until the Department has completed its evaluation of those submissions, and I have had a chance to review them. In addition, I believe we must seek bipartisan support for tax reform, and I want to consult with interested Members of Congress in an attempt to fashion a bipartisan consensus on a tax reform package.

6. Do you believe the present system for depreciating business assets should be preserved?

Answer:

Again, it would be premature for me to speculate about the changes I will propose. The Treasury Department is considering a number of options in this area, and I want to review them before I make any comment. However, I do believe that any decision in this area must reconcile the competing objectives of incentives for economic growth, fairness and neutrality toward economic decision-making.

7. Do you support elimination of investment tax credits? The Treasury tax reform proposal would do away with the current law that allows expensing of intangible drilling costs. Is that something you support?

Answer:

Again, the ITC and expensing of intangible drilling costs are areas under active consideration, and it would be premature for me to speculate about what I will ultimately support.

8. Do you support the elimination of percentage depletion? The Treasury tax reform proposal would eliminate the deduction for charitable contributions except to the extent they exceed two percent of adjusted gross income. Do you agree with that proposal?

Answer:

The issue of percentage depletion falls in the same general category as the investment tax credit and expensing of intangible drilling costs. I simply cannot speculate at this point about the outcome of our deliberations at Treasury.

I realize that the Treasury proposal to limit the deduction for charitable contributions to the excess over two percent of adjusted gross income has stirred up considerable controversy. Like everything else, we will be re-examining that issue. But let me say right now that we would not want to propose changes in the tax treatment of charitable contributions that would have a significant adverse effect on the ability of nonprofit institutions in the private sector to discharge their traditional responsibilities.

9. The Treasury tax reform proposal recommends eliminating the deduction allowed for long-term capital gains. Is that something you support?

Answer:

We believe strongly in the importance of invention, innovation, risk-taking, and investment as vehicles of economic growth. We will therefore be considering carefully the inter-relationship between the taxation of capital gains and these types of activities. Again, it would be premature for me to pre-judge the outcome of our deliberations.

10. Do you support legislation providing for tuition tax credits?

Answer:

Yes, I continue to support the President's proposal for legislation that would provide tuition tax credits.

11. Do you support now, or can you envision supporting in the future, an import fee on oil imports?

Answer:

Certainly we would not propose such a tax as a means of raising revenue; the President wants no tax increases.

12. As you may be aware, the Treasury Department's Tax Reform Proposal recommends the elimination of Section 401(k) cash or deferred arrangement plans. These plans allow employees to save amounts for their retirement on a pre-tax basis. There are estimates that at least eight million employees participate in this type of plan; most of these participants are classified as rank and file employees, not the higher paid employees. Do you believe this opportunity to save for retirement should be repealed?

Answer:

I should note that the Treasury proposal does not just repeal section 401(k). It would substitute an expansion of individual retirement accounts for existing 401(k) cash or deferred arrangement plans. This proposal is a useful starting point for our consideration, but I will want to reconsider that issue before making any decision on what to propose to the President.

13. Most profit sharing plans pay out lump sum distributions to employees at retirement. These monies are then used by the retiring employees to provide for their own retirement security. Are you aware that in the case of retiring employees, especially the lower paid employees, the Treasury proposal would almost double and sometimes even triple the tax paid on lump sum distributions?

Answer:

I must confess that I do not know in detail the possible effects of all the many proposals in the Treasury Department study. I would doubt that the typical low-income retiree would experience the kind of increase in tax liability you mention, because of the possibility of rolling over a lump-sum distribution into an IRA from which it could be withdrawn gradually over the course of retirement and therefore taxed at low rates, if at all.

14. Congress has provided for favorable tax treatment on lump sums because they represent retirement income accumulated over a long period--sometimes the employee's entire working career. This "bunched" income in the year of retirement should not be subject to the employee's highest marginal tax bracket. Do you believe that favorable tax treatment is needed for lump sum distributions?

Answer:

Of course, favorable tax treatment is already provided for lump-sum distributions because they can be rolled over into an IRA where they would remain untaxed until withdrawn. Because withdrawals would be spread over the period of retirement, it is very unlikely that they would be taxed at high marginal rates.

15. The Treasury tax proposals would eliminate all of the existing ESOP provisions, including the employer's tax credit for his contributions. It would also tax the employee on employer stock distributed to him at its market value rather than at its cost, if lower. Existing law encourages employee ownership as a means of increasing employee incentives and rewards and thereby labor productivity. Do you support this aspect of the Treasury tax reform proposal?

Answer:

Elimination of existing ESOP provisions is another of the many proposals in the Treasury Department tax study that have been questioned and are undergoing re-evaluation. Since this Administration is vitally interested in employee incentives and labor productivity, you can be sure that proposals in this area will reflect careful appraisal of their effects on labor markets.

16. Today the International Trade Commission begins a 201 investigation for the nonrubber footwear industry. In 1984 that industry lost 72 percent of its market to imports. 89 factories closed and 10,000 employees lost their jobs. Assuming that the ITC finds in the affirmative this time the case will be forwarded to the White House this July.

What will be your position as Secretary of the Treasury and a member of the Trade Policy Review Group on import relief for domestic industries?

Answer:

The Reagan Administration stands ready to provide import relief to domestic industries being injured by increased imports. The USITC last year determined that the domestic shoe industry was not being so injured. I can't prejudge what finding they will make in this new investigation, nor could I speculate on what actions the Administration might deem appropriate if and when a positive finding is made. We'll have to wait and see what they decide and what their detailed analysis suggests for possible further actions.

Written Questions of Senator Murkowski

Hearing on the Nomination of James Baker to be Secretary of the Treasury

1. Do you believe that the Federal Government should not interfere with State unitary taxes and severance taxes? It is the position of the states that this is a matter for state legislation because of traditional congressional policy and Tenth Amendment arguments.

Answer:

The Constitution provides that state and local governments should have wide latitude in tax policy, subject to not contravening the due process and commerce clauses. As a result, the Federal Government has hardly ever seriously considered important restrictions on the taxing powers of state and local governments. I would certainly hope that this traditional posture can be maintained. Yet one must recognize that state tax policies sometimes raise important Federal issues, particularly where interstate and foreign commerce are concerned. Because of concerns expressed by our foreign trading partners, in late 1983 the President asked Secretary of the Treasury Donald Regan to convene the Worldwide Unitary Taxation Working Group. That Working Group made a concerted effort to reconcile the competing objectives of states, foreign governments, and multinational firms, and I think has met with substantial success in achieving that objective. The Working Group did so in a way that involves voluntary state action complemented by Federal assistance, rather than Federal limitations on state taxing powers. I fully share Secretary Regan's expectations that voluntary state action will resolve this troublesome problem.

Because of the unequal distribution of mineral resources in the United States, high severance taxes imposed by some mineral producing states have been viewed by other states as an unfair exportation of tax burden. These matters have been litigated and resolved by the states without Federal intervention. With respect to tax policy, state severance taxes are fully deductible expenses for the purpose of the Federal individual and corporate income tax. Limitations have been placed on the magnitude of state oil severance taxes which might be used to reduce the windfall profit tax, but these limitations were designed merely to discourage states from increasing their existing severance tax rates in order to capture a portion of this Federal excise tax. As with unitary taxation, I would hope that the remaining issues involving severance taxes can be resolved by the states without Federal intervention.

2. Do you support the proposal in the Treasury Department report to the President that eliminates the exemption from Federal income tax for certain bonds issued by states and local governments? For example, qualified veterans' mortgage bonds would be eliminated by this proposal. It would also do away with the small issue industrial development bond program which has been a valuable tool in many states for economic development.

Answer:

The Treasury Department has received expressions of concern about its proposal to eliminate the income tax exclusion for interest on certain bonds issued by state and local governments for private purposes. Since those submissions are still being received and evaluated, it would be premature for me to comment at this time on whether or not I would support this proposal.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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(405) 325-5474, 360-6220

TESTIMONY SUBMITTED TO: SENATOR BOB PACKWOOD, CHAIRMAN OF THE SENATE COMMITTEE ON FINANCE

DATE OF HEARING: JANUARY 23, 1985

SUBJECT OF HEARING: NOMINATION OF JAMES A. BAKER III TO BE SECRETARY OF THE TREASURY

STATEMENT:

Our organization, BLACKS IN INTERNATIONAL LAW, is writing to support the nomination by President Reagan of James A. Baker III to be Secretary of the Treasury.

For the past four years we have been following the actions of the National Advisory Council on International Monetary and Financial Policies. Upon confirmation as Secretary of the Treasury James A. Baker III will become Chairman of this Council.

Our interaction with Mr. Baker leads us to confidently believe he will continue to emphasize the need for the developing countries (LDCs) to adopt sound, market-oriented economic policies and the need for strengthening existing institutions and mechanisms rather than adopting destabilizing institutional changes.

We strongly support the initiatives by the United States to broaden and deepen its efforts to increase the effective use of bilateral development assistance, while actively supporting related private enterprise activities.

We believe the United States should continue to work with LDCs to improve their macro-economic and sectoral policy environments as a means of maximizing aid effectiveness and facilitating private sector resource flows.

BLACKS IN INTERNATIONAL LAW
Ophelia Jatta, President

NOMINATION OF JAMES A. BAKER III TO BE SECRETARY OF THE TREASURY
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Our organization is certain that a key ingredient to LDCs economic self-sufficiency is developing and encouraging private entrepreneurship. We feel this the the view of Mr. Baker therefore we unanimously endorse his nomination.

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NAFCU
National Association of Federal Credit Unions
P.O. Box 3769
Washington, DC 20007
703/522-4770

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January 22, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Packwood:

The National Association of Federal Credit Unions, the only national organization exclusively representing the interests of credit unions chartered by the federal government, endorses the nomination of the Honorable James A. Baker III to the post of Secretary of the Treasury.

Much of President Reagan's legislative success over the past four years has been attributed to the pragmatic good judgement and even handed treatment of various interests exercised by Mr. Baker as White House Chief of Staff. The chances for achieving deficit reduction and tax simplification, perhaps the two greatest challenges the President faces in his second term, will be greatly enhanced by the politically seasoned leadership Mr. Baker will bring to the Treasury Department.

NAFCU encourages the Finanace Comittee to act promptly and favorably on this nomination.

Sincerely,

Kenneth L. Robinson

Kenneth L. Robinson
Executive Vice President

KLR:dm

National Association of Home Builders
15th and M Streets, N.W., Washington, D.C. 20005
Telex 89-2600 (202) 822-0400 (800) 368-5242

Peter D. Herder
1984 President

1985 JAN 23 PM 1 40

January 21, 1985

Honorable Bob Packwood
Chairman
Senate Finance Committee
219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the 130,000 members of the National Association of Home Builders, I am writing to express our enthusiastic support for the nomination of James A. Baker III as Secretary of the Treasury. We have observed Jim Baker in his current position as Chief of Staff and Assistant to the President and have found him to be extremely competent, a masterful legislative strategist, and accessible to members of the business community.

Jim Baker has had a long and distinguished career in the public and private sector. He practiced law for twenty-three years, served as Under Secretary of Commerce, and was appointed to leadership capacities in a number of Presidential campaigns.

We feel that his extraordinary background makes him extremely well qualified to serve in the President's Cabinet as Treasury Secretary. We urge rapid confirmation so that Jim Baker may begin the arduous task of promoting continued economic growth, increased savings and investment, and capital formation which will sustain a long-term economic recovery.

I respectfully request that this letter be made part of the record of confirmation hearings for Mr. Baker before your distinguished Committee.

Sincerely yours,

Peter D. Herder

Peter D. Herder
President